T19/68/980-4

MISCELLANEOUS TAX BILLS VIII

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

NINETY-SIXTH CONGRESS

SECOND SESSION

ON

S. 1614, S. 2075, S. 2493, S. 2547, S. 2646, S. 2660, S. 2757, S. 2766, S. 2783, S. 2784, H.R. 5391

JUNE 24, 1980

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MISCELLANEOUS TAX BILLS VIII

TUESDAY, JUNE 24, 1980

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2 p.m., in room 2221, Dirksen Senate Office Building, Hon. Harry F. Byrd, Jr. (chairman of the subcommittee) presiding.

[The press release announcing this hearing, the bills S. 1614, S. 2075, S. 2493, S. 2547, S. 2646, S. 2660, S. 2757, S. 2766, S. 2783, S. 2784, H.R. 5391 and joint committee print describing the above bills follow:]

Press Release #H-32

PRESS RELEASE

FOR IMMEDIATE RELEASE
June 6, 1980

COMMITTEE ON FINANCE
UNITED STATES SENATE
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT
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FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT SETS HEARINGS ON MISCELLANEOUS TAX BILLS

Senator Harry F. Byrd, Jr., Chairman of the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance announced today that the Subcommittee will hold a hearing on Tuesday, June 24, 1980, on miscellaneous tax bills.

The hearing will begin at 2:00 p.m. in Room 2221 of the Dirksen Senate Office Building.

The following measures, of general application unless otherwise specified, will be considered. Revenue estimates and any particular taxpayers affected by this legislation, in addition to taxpayers listed below, will be furnished at the hearing.

S. 1614 --	Introduced by Senator Bentsen. Would exempt holdings of independent local newspapers from the tax on excess business holdings of private foundations.
S. 2075 --	Introduced by Senator Gravel. Would include in the definition of an affiliated group for purposes of the transportation excise tax, unions and their tax-exempt trusts and wholly owned corporations. Amounts paid to one member of a group by another member of that group for air transportation, would be exempt from the tax.
S. 2493 --	Introduced by Senator Glenn. Would extend the time for payment of the manufacturers excise tax on tires, tubes, etc., until 90 days after the close of the month in which the article is sold.
S. 2547 --	Introduced by Senator Gravel and others. Would permit certain facilities constructed to comply with beverage container laws to be financed with tax-exempt bonds.
S. 2646 --	Introduced by Senator Boren. Would exclude from income certain interest earned on savings accounts of up to $100,000 provided the principal is used for designated investment purposes.
S. 2660 --	Introduced by Senator Moynihan. Would permit cities which consist of more than two counties to finance facilities which decompose garbage and recapture the gaseous byproducts. The principal beneficiary would be the City of New York.
S. 2757 --	Introduced by Senators Bentsen, Danforth, Heinz and Stevenson. Would provide special provisions for the taxation of export trading companies.
S. 2766 --	Introduced by Senator Gravel. Would eliminate the two county rule and the public use test with respect to the issuance of tax-exempt bonds to finance hydroelectric facilities.
S. 2783 --	Introduced by Senators Wallop and Garn. Would expand the definition of oil shale property eligible for the

energy investment tax credit to include equipment used in hydrogeneration or a similar upgrading process.

S. 2784 -- Introduced by Senator Gravel. Would change the effective date for amendments made by the Crude Oil Windfall Profit Tax Act of 1980 relating to the investment tax credit for coke ovens. The bill would make the effective date September 30, 1978 rather than December 31, 1979.

H.R. 5391 -- (S. 2485 introduced by Senator Long.) Would amend the provisions relating to the imposition of second tier taxes on private foundations.

Witnesses who desire to testify at the hearing must submit a written request, including a mailing address and phone number, to Michael Stern, Staff Director, Committee on Finance, Room 2227 Dirksen Senate Office Building, Washington, D. C. 20510, by no later than the close of business on June 17, 1980.

Consolidated Testimony.--Senator Byrd also stated that the Committee urges all witnesses who have a common position or the same general interest to consolidate their testimony and designate a single spokesman to present their common viewpoint orally to the Committee. This procedure will enable the Committee to receive a wider expression of views than it might otherwise obtain. The Chairman urges very strongly that all witnesses exert a maximum effort, taking into account the limited advance notice, to consolidate and coordinate their statements.

Legislative Reorganization Act.--Senator Byrd stated that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

Witnesses scheduled to testify should comply with the following rules:

(1) A copy of the statement must be filed by noon the day before the day the witness is scheduled to testify.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least 100 copies must be submitted by the close of business the day before the witness is scheduled to testify.

(4) Witnesses are not to read their written statements to the Subcommittee, but are to confine their oral presentations to a summary of the points included in the statement.

Written Statements.--Witnesses who are not scheduled to make an oral presentation, and others who desire to present their views to the Subcommittee, are urged to prepare a written statement for submission and inclusion in the printed record of the hearings. These written statements should be typewritten, not more than 25 double-spaced pages in length, and mailed with five (5) copies to Michael Stern, Staff Director, Committee on Finance, Room 2227, Dirksen Senate Office Building, Washington, D. C. 20510, not later than July 11, 1980.

P.R. # H-32

II

96th CONGRESS
1st Session

S. 1614

To amend the Internal Revenue Code of 1954 to exempt holdings in independent local newspapers from taxes on excess business holdings of private foundations.

IN THE SENATE OF THE UNITED STATES

August 1 (legislative day, June 21), 1979

Mr. Bentsen introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to exempt holdings in independent local newspapers from taxes on excess business holdings of private foundations.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) paragraph (4) of section 4943(d) of the Internal Revenue Code of 1954 (relating to taxes on excess business holdings) is amended—

(1) by striking out "or" at the end of subparagraph (A),

(2) by striking out the period at the end of subparagraph (B) and inserting in lieu thereof ", or", and

(3) by inserting after subparagraph (B) the following new subparagraph:

"(C) an independent local newspaper business (as defined in paragraph (5))."

(b) Subsection (d) of section 4943 of such Code is amended by adding at the end thereof the following new paragraph:

"(5) INDEPENDENT LOCAL NEWSPAPER BUSINESS.—For purposes of paragraph (4)—

"(A) IN GENERAL.—The term 'independent local newspaper business' means—

"(i) a proprietorship which publishes an independent local newspaper;

"(ii) a partnership which publishes an independent local newspaper and which has none of its outstanding partnership interests traded in an established securities market; and

"(iii) a corporation which publishes an independent local newspaper and which has none of its outstanding capital stock traded in an established securities market.

"(B) INDEPENDENT LOCAL NEWSPAPER.—The term 'independent local newspaper' means a newspaper publication which is not one of a chain of newspaper publications and which has all of its publishing offices (containing its principal editorial, reportorial, circulation, and business staff) in a single city, community, or metropolitan area, or, on January 1, 1979, within one State.

"(C) A CHAIN OF NEWSPAPER PUBLICATIONS.—The term 'a chain of newspaper publications' means two or more newspaper publications which are not published in a single city, community, or metropolitan area or, on January 1, 1979, within one State and are controlled, directly or indirectly, by the same person or persons."

(c) The amendments made by this Act shall apply to taxable years ending after the date of the enactment of this Act.

II

96TH CONGRESS
1ST SESSION

S. 2075

To amend the Internal Revenue Code of 1954 to include as an affiliated group for purposes of the transportation excise tax union locals and their tax-exempt trusts and wholly owned corporations, and for other purposes.

IN THE SENATE OF THE UNITED STATES

DECEMBER 4 (legislative day, NOVEMBER 29), 1979

Mr. GRAVEL introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to include as an affiliated group for purposes of the transportation excise tax union locals and their tax-exempt trusts and wholly owned corporations, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That (a) subsection (b) of section 4284 of the Internal Revenue Code of 1954 (relating to excise tax on transportation by air for members of affiliate group) is amended by striking out everything after the words "'affiliated group'" and inserting in lieu thereof:

"(1) has the meaning assigned to such term by section 1504(a) except that all corporations shall be treated as includible corporations (without any exclusion under section 1504(b)), and

"(2) shall include a labor organization exempt under section 501 together with the following organizations:

"(A) any trusts, also exempt under section 501, which are established for the sole and exclusive benefit of the members of such labor organization and their families and dependents; and

"(B) any corporations wholly owned by a trust described in subparagraph (A).".

II

96TH CONGRESS
2D SESSION

S. 2493

To amend the Internal Revenue Code of 1954 to adjust the time for payment of manufacturers excise tax on tires, tubes, and tread rubber.

IN THE SENATE OF THE UNITED STATES

MARCH 28 (legislative day, JANUARY 3), 1980

Mr. GLENN introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to adjust the time for payment of manufacturers excise tax on tires, tubes, and tread rubber.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. IN GENERAL.

Section 6302 of the Internal Revenue Code of 1954 (relating to mode or time of collection of taxes) is amended by redesignating subsection (d) as subsection (e) and by inserting after subsection (c) the following new subsection:

"(d) TIME FOR PAYMENT OF MANUFACTURERS EXCISE TAX ON TIRES, TUBES, ETC.—The tax imposed by section 4071(a) (relating to manufacturers excise tax on tires, tubes, and tread rubber) shall be due and payable 90 days after the last day of the month in which the manufacturer, producer, or importer of articles subject to tax under that section sells such articles.".

SEC. 2. EFFECTIVE DATE.

The amendments made by the first section of this Act shall apply to tires, tubes, and tread rubber sold on or after the first month beginning after the date of enactment of this Act.

II

96TH CONGRESS
2D SESSION

S. 2547

To amend the Internal Revenue Code of 1954 with respect to State or local government obligations issued to finance certain beverage container facilities the construction of which is made necessary by an antidisposable beverage container law.

IN THE SENATE OF THE UNITED STATES

APRIL 3 (legislative day, JANUARY 3), 1980

Mr. GRAVEL (for himself, Mr. HATFIELD, Mr. LEVIN, and Mr. HAYAKAWA) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 with respect to State or local government obligations issued to finance certain beverage container facilities the construction of which is made necessary by an antidisposable beverage container law.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. QUALIFIED BEVERAGE CONTAINER FACILITIES.

(a) In General.—Paragraph (4) of section 103(b) of the Internal Revenue Code of 1954 (relating to certain exempt activities) is amended—

(1) by striking out "or" at the end of subparagraph (G),

(2) by striking out the period at the end of subparagraph (H) and inserting in lieu thereof a comma and "or", and

(3) by inserting after subparagraph (H) the following new subparagraph:

"(I) qualified beverage container facilities.".

(b) Qualified Beverage Container Facility Defined.—Subsection (b) of section 103 of such Code is amended by redesignating paragraph (9) as paragraph (10), and by inserting after paragraph (8) the following new paragraph:

"(9) Qualified beverage container facilities.—For purposes of this section—

"(A) In general.—The term 'qualified beverage container facility' means a beverage container facility—

"(i) the construction, reconstruction, erection, or acquisition of which occurs during the period beginning on the date of enactment of a beverage container law applicable to containers in connection with which such facility is used and ending on the date which is 2 years after the effective date of such law,

"(ii) which does not replace an existing beverage container facility, and

"(iii) which is used in connection with a beverage container law.

"(B) BEVERAGE CONTAINER FACILITY.—The term 'beverage container facility' means the initial supply of refillable beverage containers and shells, plus any facility used by a distributor or bottler of beverages—

"(i) in the collection, sorting, handling, or storage of beverage containers,

"(ii) in the cleaning and processing of refillable beverage containers, or

"(iii) for the manufacture of metal beverage container tops with nondetachable opening devices where a beverage container law requires them.

"(C) BEVERAGE CONTAINER LAW.—The term 'beverage container law' means a law which—

"(i) requires the purchaser of beverages sold in containers to pay a deposit or fee to the seller in connection with the purchase of such beverages,

"(ii) prohibits or discourages the sale of beverages in nonreturnable containers, or

"(iii) prohibits or discourages the sale of beverages in metal containers unless the containers have nondetachable opening devices.".

SEC. 2. EFFECTIVE DATE.

(a) IN GENERAL.—The amendments made by section 1 of this Act shall apply with respect to obligations issued after December 31, 1979.

(b) SPECIAL RULES.—The cost of a qualified beverage container facility described in section 103(b)(4)(I) of the Internal Revenue Code of 1954 shall be treated as an amount which is chargeable to capital account. Such a facility shall not be treated as a facility not described in section 1.103-8(a)(5)(iv) of the Income Tax Regulations solely because the facility was used by a substantial user (within the meaning of such regulations) before the date of issue of the State or local obligation used to provide the facility if—

(1) a bond resolution was adopted, or other similar official action was taken, by the issuer of the obli-

gations before the commencement of the construction, reconstruction, erection, or acquisition of such facility, and

(2) such obligations are issued no later than one year after the date of enactment of this Act.

II

96TH CONGRESS
2D SESSION

S. 2646

To amend the Internal Revenue Code of 1954 to provide for the exclusion from income of interest on certain savings.

IN THE SENATE OF THE UNITED STATES

MAY 2 (legislative day, JANUARY 3), 1980

Mr. BOREN introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 to provide for the exclusion from income of interest on certain savings.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Save America Savings Account Act of 1980".

SEC. 2. EXCLUSION OF CERTAIN INTEREST FROM INCOME.

(a) IN GENERAL.—Part III of subchapter B of chapter 1 of the Internal Revenue Code of 1954 (relating to items specifically excluded from gross income) is amended by redesignating section 128 as section 129, and by inserting after section 127 the following new section:

"**SEC. 128. CERTAIN INTEREST.**

"(a) IN GENERAL.—In the case of an individual, gross income shall not include amounts received as qualified interest for the taxable year.

"(b) LIMITATION.—Subsection (a) shall not apply with respect to any qualified interest paid with respect to amounts on deposit in excess of $100,000 for the taxable year.

"(c) APPLICATION WITH SECTION 116.—Amounts excluded from gross income under subsection (a) shall be in addition to any amounts excludible under section 116 for the taxable year.

"(d) QUALIFIED INTEREST DEFINED.—For the purpose of this section—

"(1) IN GENERAL.—The term 'qualified interest' means interest described in subparagraph (A) or (B) of section 116(c)(1) which is paid at a rate not in excess of 7 percent per year, but only if the principal with respect to which the interest is payable—

"(A) is held on deposit for not less than 1 year, and

"(B) is used (exclusive of reserve requirements imposed by law) for the purpose of making qualified loans.

"(2) QUALIFIED LOAN.—The term 'qualified loan' means a loan—

"(A) for any of the following purposes:

"(i) the purchase of owner-occupied residential property,

"(ii) the operation of a trade or business, or

"(iii) the operation of a farm for farming purposes (within the meaning of section 2032A(e)(5)); and

"(B) the rate of interest payable on which does not exceed by more than 21/2 percentage points the rate of interest paid on the amounts from which the loan is made

"(3) LOANS TO ACQUIRE CERTAIN REAL PROPERTY NOT TO QUALIFY.—No loan, other than for the purchase of owner-occupied residential property, shall be treated as a qualified loan if it is used, in part or in whole, for the purchase of land.".

(b) CLERICAL AMENDMENT.—The table of sections for such part is amended by striking out the last item and inserting in lieu thereof the following:

"Sec. 128. Certain interest.
"Sec. 129. Cross references to other Acts.".

SEC. 3. PENALTY FOR FAILURE TO MEET QUALIFIED LOAN REQUIREMENTS.

Any person who—

(1) uses the proceeds of a qualified loan (as defined in section 128(d)(2) of the Internal Revenue Code of 1954) for a purpose other than a purpose described in section 128(d)(2)(A) of such Code, or

(2) charges interest at a rate in excess of the rate permitted on such loans under section 128(d)(2)(B) of such Code,

shall be guilty of a violation of section 7201 of such Code (relating to attempt to evade or defeat tax).

SEC. 4. EFFECTIVE DATE.

The amendments made by section 2 shall apply with respect to taxable years beginning after December 31, 1979.

II

96TH CONGRESS
2D SESSION

S. 2660

To clarify the definition of the term "local furnishing" in the Internal Revenue Code of 1954.

IN THE SENATE OF THE UNITED STATES

MAY 6 (legislative day, JANUARY 3), 1980

Mr. MOYNIHAN introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To clarify the definition of the term "local furnishing" in the Internal Revenue Code of 1954.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. Section 103(b) of the Internal Revenue Code of 1954 (relating to projects for which tax-exempt "industrial development bonds" may be issued) is amended by inserting the words "or gas" between "energy" and "from" in the last sentence of paragraph (4).

SEC. 2. The amendment made by this Act shall apply to obligations issued after the date of enactment.

II

96TH CONGRESS
2D SESSION

S. 2757

To encourage exports and the expansion of export trade services by providing for special provisions on taxation of export trading companies.

IN THE SENATE OF THE UNITED STATES

MAY 22 (legislative day, JANUARY 3), 1980

Mr. BENTSEN (for himself, Mr. STEVENSON, Mr. HEINZ, and Mr. DANFORTH) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To encourage exports and the expansion of export trade services by providing for special provisions on taxation of export trading companies.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. (a) Paragraph (3) of section 992(d) of the Internal Revenue Code of 1954 (relating to ineligible corporations) is amended by inserting before the comma at the end thereof the following: "(other than a financial institution which is a banking organization as defined in section 105(a)(1) of the Export Trading Company Act of 1980 investing in the voting stock of an export trading company (as defined in section 103(5) of the Export Trading Act of 1980) in accordance with the provisions of section 105 of such Act)".

(b) Paragraph (1) of section 993(a) of the Internal Revenue Code of 1954 (relating to qualified export receipts of a DISC) is amended—

(1) by striking out "and" at the end of subparagraph (G),

(2) by striking out the period at the end of subparagraph (H) and inserting in lieu thereof "and", and

(3) by adding at the end thereof the following new subparagraph:

"(I) in the case of a DISC which is an export trading company (as defined in section 103(5) of the Export Trading Company Act of 1980), or which is a subsidiary of such a company, gross receipts from the export of services produced in the United States (as defined in section 103(3) of such Act) or from export trade services (as defined in section 103(4) of such Act).".

(c) The Secretary of Commerce, after consultation with the Secretary of the Treasury, shall develop, prepare, and distribute to interested parties, including potential exporters, information concerning the manner in which an export trading company can utilize the provisions of part IV of subchapter N of chapter 1 of the Internal Revenue Code of 1954 (relating to domestic international sales corporations), and any advantages or disadvantages which may reasonably be expected from the election of DISC status or the establishment of a subsidiary corporation which is a DISC.

(d) The amendments made by this section shall apply with respect to taxable years beginning after December 31, 1980.

SUBCHAPTER S STATUS FOR EXPORT TRADING COMPANIES

SEC. 2. (a) Paragraph (2) of section 1371(a) of the Internal Revenue Code of 1954 (relating to the definition of a small business corporation) is amended by inserting ", except in the case of the shareholders of an export trading company (as defined in section 103(5) of the Export Trading Company Act of 1980) if such shareholders are otherwise small business corporations for the purpose of this subchapter," after "shareholder".

(b) The first sentence of section 1372(e)(4) of such Code (relating to foreign income) is amended by inserting ", other than an export trading company," after "small business corporation".

(c) The amendments made by this section shall apply with respect to taxable years beginning after December 31, 1980.

96TH CONGRESS
2D SESSION

S. 2766

To amend the Internal Revenue Code of 1954 with respect to the treatment of interest on bonds sold to finance the construction of hydroelectric facilities.

IN THE SENATE OF THE UNITED STATES

MAY 28 (legislative day, JANUARY 3), 1980

Mr. GRAVEL introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 with respect to the treatment of interest on bonds sold to finance the construction of hydroelectric facilities.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. TAX EXEMPT FINANCING FOR HYDROELECTRIC FACILITIES.

(a) SHORT TITLE.—This Act may be cited as the "Hydropower Development Act of 1980".

(b) ELIGIBILITY FOR TAX EXEMPT FINANCING.—Subsection (b) of section 103 of the Internal Revenue Code of

1954 (relating to interest on certain governmental obligations) is amended—

(1) by striking out "qualified hydroelectric generating facilities" in paragraph (4)(H) and inserting in lieu thereof "facilities the primary purpose of which is the generating of hydroelectric power"; and

(2) by striking out paragraph (9) and redesignating paragraph (9) as paragraph (8).

SEC. 2. EFFECTIVE DATE.

The amendments made by this Act shall apply with respect to obligations issued after the date of enactment of this Act.

II

96TH CONGRESS
2D SESSION

S. 2783

To amend the Internal Revenue Code of 1954 with respect to the treatment of certain shale oil property as energy property for purposes of the energy investment credit.

IN THE SENATE OF THE UNITED STATES

JUNE 4 (legislative day, JANUARY 3), 1980

Mr. WALLOP (for himself and Mr. GARN) introduced the following bill; which was read twice and referred to the Committee on Finance

---

A BILL

To amend the Internal Revenue Code of 1954 with respect to the treatment of certain shale oil property as energy property for purposes of the energy investment credit.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. TREATMENT OF CERTAIN SHALE OIL PROPERTY AS ENERGY PROPERTY.

(a) IN GENERAL.—Paragraph (7) of section 48(l) of the Internal Revenue Code of 1954 (relating to energy property) is amended to read as follows:

"(7) **Shale oil property.**—The term 'shale oil property' means property used in the production or extraction of oil from oil-bearing shale rock, including property used for hydrogenation (or for a similar process subsequent to retorting), but not including property used for refining.".

(b) **Conforming Amendment.**—Clause (v) of section 48(l)(2)(A) of such Code (relating to definition of energy property) is amended by striking out "equipment" and inserting in lieu thereof "property".

SEC. 2. EFFECTIVE DATE.

The amendments made by section 1 shall apply to periods after December 31, 1980, under rules similar to the rules of section 48(m) of the Internal Revenue Code of 1954.

96TH CONGRESS
2D SESSION

S. 2784

To amend the Crude Oil Windfall Profit Tax Act of 1980 with respect to the effective date for changes in the investment credit relating to coke ovens.

IN THE SENATE OF THE UNITED STATES

JUNE 4 (legislative day, JANUARY 3), 1980

Mr. GRAVEL introduced the following bill; which was read twice and referred to the Committee on Finance

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A BILL

To amend the Crude Oil Windfall Profit Tax Act of 1980 with respect to the effective date for changes in the investment credit relating to coke ovens.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That subsection (j) of section 222 of the Crude Oil Windfall Profit Tax Act of 1980 (relating to effective dates) is amended—

(1) by striking out "paragraph (2)" in paragraph (1) and inserting in lieu thereof "paragraphs (2) and (3)", and

(2) by adding at the end thereof the following new paragraph:

"(3) **Coke ovens.**—The amendments made by paragraphs (1) and (2) of subsection (b) shall apply to periods after September 30, 1978, under rules similar to the rules of section 48(m) of such Code.".

II

96TH CONGRESS
2D SESSION

H. R. 5391

IN THE SENATE OF THE UNITED STATES

MAY 22 (legislative day, JANUARY 3), 1980

Read twice and referred to the Committee on Finance

AN ACT

To amend chapter 42 of the Internal Revenue Code of 1954 with respect to the determination of second tier taxes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; AMENDMENT OF 1954 CODE.

(a) SHORT TITLE.—This Act may be cited as the "Chapter 42 Second Tier Tax Correction Act of 1980".

(b) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. DATE FOR DETERMINING AMOUNT OF SECOND TIER TAXES.

(a) **Substitution of Taxable Period for Correction Period.**—The following provisions are each amended by striking out "correction period" and inserting in lieu thereof "taxable period":

(1) Section 4941(b)(1) (relating to additional taxes on self-dealer).

(2) Section 4941(e)(2)(B) (defining amount involved).

(3) Section 4942(b) (relating to additional tax on failure to distribute income).

(4) Section 4943(b) (relating to additional tax on excess business holdings).

(5) Section 4944(b)(1) (relating to additional taxes on investments which jeopardizes charitable purpose).

(6) Section 4945(b)(1) (relating to additional taxes on taxable expenditures).

(7) Section 4951(b)(1) (relating to additional taxes on self-dealer).

(8) Section 4951(e)(2)(B) (defining amount involved).

(9) Section 4952(b)(1) (relating to additional taxes on taxable expenditures).

(10) Section 4971(b) (relating to additional tax on failure to meet minimum funding standards).

(11) Section 4975(b) (relating to additional taxes on disqualified persons).

(12) Section 4975(f)(4)(B) (defining amount involved).

(b) DEFINITION OF TAXABLE PERIOD.—

(1) Paragraph (1) of section 4941(c) (defining taxable period) is amended to read as follows:

"(1) TAXABLE PERIOD.—The term 'taxable period' means, with respect to any act of self-dealing, the period beginning with the date on which the act of self-dealing occurs and ending on the earliest of—

"(A) the date of mailing a notice of deficiency with respect to the tax imposed by subsection (a)(1) under section 6212,

"(B) the date on which the tax imposed by subsection (a)(1) is assessed, or

"(C) the date on which correction of the act of self-dealing is completed."

(2) Paragraph (1) of section 4942(j) is amended to read as follows:

"(1) Taxable period.—The term 'taxable period' means, with respect to the undistributed income for any taxable year, the period beginning with the first day of the taxable year and ending on the earlier of—

"(A) the date of mailing of a notice of deficiency with respect to the tax imposed by subsection (a) under section 6212, or

"(B) the date on which the tax imposed by subsection (a) is assessed."

(3) Paragraph (2) of section 4943(d) is amended to read as follows:

"(2) Taxable period.—The term 'taxable period' means, with respect to any excess business holdings of a private foundation in a business enterprise, the period beginning on the first day on which there are excess holdings and ending on the earlier of—

"(A) the date of mailing of a notice of deficiency with respect to the tax imposed by subsection (a) under section 6212 in respect of such holdings, or

"(B) the date on which the tax imposed by subsection (a) in respect of such holdings is assessed."

(4) Paragraph (1) of section 4944(e) is amended to read as follows:

"(1) Taxable period.—The term 'taxable period' means, with respect to any investment which jeopardizes the carrying out of exempt purposes, the period beginning with the date on which the amount is so invested and ending on the earliest of—

"(A) the date of mailing of a notice of deficiency with respect to the tax imposed by subsection (a)(1) under section 6212,

"(B) the date on which the tax imposed by subsection (a)(1) is assessed, or

"(C) the date on which the amount so invested is removed from jeopardy."

(5) Paragraph (2) of section 4945(i) is amended to read as follows:

"(2) Taxable period.—The term 'taxable period' means, with respect to any taxable expenditure, the period beginning with the date on which the taxable expenditure occurs and ending on the earlier of—

"(A) the date of mailing a notice of deficiency with respect to the tax imposed by subsection (a)(1) under section 6212, or

"(B) the date on which the tax imposed by subsection (a)(1) is assessed."

(6) Paragraph (1) of section 4951(e) is amended to read as follows:

"(1) TAXABLE PERIOD.—The term 'taxable period' means, with respect to any act of self-dealing, the period beginning with the date on which the act of self-dealing occurs and ending on the earliest of—

"(A) the date of mailing a notice of deficiency with respect to the tax imposed by subsection (a)(1) under section 6212,

"(B) the date on which the tax imposed by subsection (a)(1) is assessed, or

"(C) the date on which correction of the act of self-dealing is completed."

(7) Paragraph (2) of section 4952(e) is amended to read as follows:

"(2) TAXABLE PERIOD.—The term 'taxable period' means, with respect to any taxable expenditure, the period beginning with the date on which the taxable expenditure occurs and ending on the earlier of—

"(A) the date of mailing a notice of deficiency with respect to the tax imposed by subsection (a)(1) under section 6212, or

"(B) the date on which the tax imposed by subsection (a)(1) is assessed."

(8) Paragraph (3) of section 4971(c) is amended to read as follows:

"(3) TAXABLE PERIOD.—The term 'taxable period' means, with respect to an accumulated funding deficiency, the period beginning with the end of the plan year in which there is an accumulated funding deficiency and ending on the earlier of—

"(A) the date of mailing of a notice of deficiency with respect to the tax imposed by subsection (a), or

"(B) the date on which the tax imposed by subsection (a) is assessed."

(9) Paragraph (2) of section 4975(f) is amended to read as follows:

"(2) TAXABLE PERIOD.—The term 'taxable period' means, with respect to any prohibited transaction, the period beginning with the date on which the prohibited transaction occurs and ending on the earliest of—

"(A) the date of mailing a notice of deficiency with respect to the tax imposed by subsection (a) under section 6212,

"(B) the date on which the tax imposed by subsection (a) is assessed, or

"(C) the date on which correction of the prohibited transaction is completed."

(c) TECHNICAL AMENDMENTS.—

(1) Subsection (e) of section 4941 is amended by striking out paragraph (4).

(2) Subsection (j) of section 4942 is amended—

(A) by striking out paragraph (2),

(B) by striking out "paragraph (5)" in paragraph (3)(B)(i) and inserting in lieu thereof "paragraph (4)",

(C) by redesignating paragraph (4) as paragraph (2), and

(D) by redesignating paragraphs (5) and (6) as paragraphs (4) and (5), respectively.

(3) Subsection (d) of section 4943 is amended by striking out paragraph (3) and by redesignating paragraph (4) as paragraph (3).

(4) Subsection (e) of section 4944 is amended by striking out paragraph (3).

(5) Subsection (e) of section 4951 is amended by striking out paragraph (4) and by redesignating paragraph (5) as paragraph (4).

(6) Subsection (f) of section 4975 is amended by striking out paragraph (6).

(d) CLERICAL AMENDMENTS.—

(1) Clause (ii) of section 4942(g)(2)(C) is amended by striking out "the initial correction period provided in subsection (j)(2)" and inserting in lieu thereof "the correction period (as defined in section 4962(e))".

(2) Subparagraph (A) of section 4943(d)(3) (as redesignated by subsection (c)) is amended by striking out "4942(j)(5)" and inserting in lieu thereof "4942(j)(4)".

(3) Subsection (e) of section 6213 (relating to suspension of filing period for certain excise taxes) is amended by striking out "section 4941(e)(4)" and all that follows through the end of such subsection and inserting in lieu thereof "section 4962(e)."

(4) Subsection (g) of section 6503 (relating to suspension of running of period of limitation pending correction) is amended by striking out "section 4941(e)(4)" and all that follows through the end of such subsection and inserting in lieu thereof "section 4962(e)."

(5) Section 6503 is amended by redesignating subsection (j) as subsection (i).

(6) The amendments made by sections 1203(h)(1) and 1601(f)(2) of the Tax Reform Act of 1976, and the amendment made by section 362(d)(5) of the Revenue Act of 1978, shall be deemed to be amendments to

section 6503(i) of the Internal Revenue Code of 1954 (as redesignated by paragraph (5)).

SEC. 3. TAX COURT TO DETERMINE WHETHER TAXABLE EVENT HAS BEEN CORRECTED.

Subsection (c) of section 6214 (relating to determinations by Tax Court) is amended by adding at the end thereof the following new sentence: "The Tax Court, in redetermining a deficiency of any second tier tax (as defined in section 4962(b)), shall make a determination with respect to whether the taxable event has been corrected."

SEC. 4. ABATEMENT OF TAX WHERE THERE IS CORRECTION DURING CORRECTION PERIOD.

(a) In General.—Chapter 42 is amended by adding at the end thereof the following new subchapter:

"Subchapter C—Abatement of Second Tier Taxes Where There Is Correction During Correction Period

"Sec. 4961. Abatement of second tier taxes where there is correction.
"Sec. 4962. Definitions.

"SEC. 4961. ABATEMENT OF SECOND TIER TAXES WHERE THERE IS CORRECTION.

"(a) General Rule.—If any taxable event is corrected during the correction period for such event, then any second tier tax imposed with respect to such event (including interest, additions to the tax, and additional amounts) shall not be assessed, and if assessed the assessment shall be abated, and if collected shall be credited or refunded as an overpayment.

"(b) Supplemental Proceeding.—If the determination by a court that the taxpayer is liable for a second tier tax has become final, such court shall have jurisdiction to conduct any necessary supplemental proceeding to determine whether the taxable event was corrected during the correction period. Such a supplemental proceeding may be begun only during the period which ends on the 90th day after the last day of the correction period. Where such a supplemental proceeding has begun, the reference in the second sentence of section 6213(a) to a final decision of the Tax Court shall be treated as including a final decision in such supplemental proceeding.

"(c) Suspension of Period of Collection for Second Tier Tax.—

"(1) Proceeding in district court or court of claims.—If, not later than 90 days after the day on which the second tier tax is assessed, the first tier tax is paid in full and a claim for refund of the amount so paid is filed, no levy or proceeding in court for the collection of the second tier tax shall be made, begun, or prosecuted until a final resolution of a proceeding begun as provided in paragraph (2) (and of any supplemental proceeding with respect thereto under subsection (b)). Notwithstanding section 7421(a), the collection by levy or proceeding may be enjoined during the time such prohibition is in force by a proceeding in the proper court.

"(2) SUIT MUST BE BROUGHT TO DETERMINE LIABILITY.—If, within 90 days after the day on which his claim for refund is denied, the person against whom the second tier tax was assessed fails to begin a proceeding described in section 7422 for the determination of his liability for such tax, paragraph (1) shall cease to apply with respect to such tax, effective on the day following the close of the 90-day period referred to in this paragraph.

"(3) SUSPENSION OF RUNNING OF PERIOD OF LIMITATIONS ON COLLECTION.—The running of the period of limitations provided in section 6502 on the collection by levy or by a proceeding in court with respect to any second tier tax described in paragraph (1) shall be suspended for the period during which the Secretary is prohibited from collecting by levy or a proceeding in court.

"(4) JEOPARDY COLLECTION.—If the Secretary makes a finding that the collection of the second tier tax is in jeopardy, nothing in this subsection shall prevent the immediate collection of such tax.

"SEC. 4962. DEFINITIONS.

"(a) First Tier Tax.—For purposes of this subchapter, the term 'first tier tax' means any tax imposed by subsection (a) of section 4941, 4942, 4943, 4944, 4945, 4951, 4952, 4971, or 4975.

"(b) Second Tier Tax.—For purposes of this subchapter, the term 'second tier tax' means any tax imposed by subsection (b) of section 4941, 4942, 4943, 4944, 4945, 4951, 4952, 4971, or 4975.

"(c) Taxable Event.—For purposes of this subchapter, the term 'taxable event' means any act (or failure to act) giving rise to liability for tax under section 4941, 4942, 4943, 4944, 4945, 4951, 4952, 4971, or 4975.

"(d) Correct.—For purposes of this subchapter—

"(1) In general.—Except as provided in paragraph (2), the term 'correct' has the same meaning as when used in the section which imposes the second tier tax.

"(2) Special rules.—The term 'correct' means—

"(A) in the case of the second tier tax imposed by section 4942(b), reducing the amount of the undistributed income to zero,

"(B) in the case of the second tier tax imposed by section 4943(b), reducing the amount of the excess business holdings to zero, and

"(C) in the case of the second tier tax imposed by section 4944, removing the investment from jeopardy.

"(e) CORRECTION PERIOD.—For purposes of this subchapter—

"(1) IN GENERAL.—The term 'correction period' means, with respect to any taxable event, the period beginning on the date on which such event occurs and ending 90 days after the date of mailing under section 6212 of a notice of deficiency with respect to the second tier tax imposed on such taxable event, extended by—

"(A) any period in which a deficiency cannot be assessed under section 6213(a) (determined without regard to the last sentence of section 4961(b)), and

"(B) any other period which the Secretary determines is reasonable and necessary to bring about correction of the taxable event.

"(2) SPECIAL RULES FOR WHEN TAXABLE EVENT OCCURS.—For purposes of paragraph (1), the taxable event shall be treated as occurring—

"(A) in the case of section 4942, on the first day of the taxable year for which there was a failure to distribute income, "(B) in the case of section 4943, on the first day on which there are excess business holdings,

"(C) in the case of section 4971, on the last day of the plan year in which there is an accumulated funding deficiency, and

"(D) in any other case, the date on which such event occurred."

(b) Civil Actions for Refunds.—Paragraph (1) of section 7422(g) (relating to special rules for certain excise taxes imposed by chapter 42 or 43) is amended to read as follows:

"(1) Right to bring actions.—

"(A) In general.—With respect to any taxable event, payment of the full amount of the first tier tax shall constitute sufficient payment in order to maintain an action under this section with respect to the second tier tax.

"(B) Definitions.—For purposes of subparagraph (A), the terms 'taxable event', 'first tier tax', and 'second tier tax' have the respective meanings given to such terms by section 4962."

(c) Clerical Amendment.—The table of subchapters for chapter 42 is amended by adding at the end thereof the following new item:

"Subchapter C. Abatement of second tier taxes where there is correction during correction period."

SEC. 5. EFFECTIVE DATES.

(a) First Tier Taxes.—The amendments made by this Act with respect to any first tier tax shall take effect as if included in the Internal Revenue Code of 1954 when such tax was first imposed.

(b) Second Tier Taxes.—The amendments made by this Act with respect to any second tier tax shall apply only with respect to taxes assessed after the date of the enactment of this Act. Nothing in the preceding sentence shall be construed to permit the assessment of a tax in a case to which, on the date of the enactment of this Act, the doctrine of res judicata applies.

(c) First and Second Tier Tax.—For purposes of this section, the terms "first tier tax" and "second tier tax" have the respective meanings given to such terms by section 4962 of the Internal Revenue Code of 1954.

Passed the House of Representatives May 20, 1980.

Attest: EDMUND L. HENSHAW, JR.,
Clerk.

By Thomas E. Ladd,
Assistant to the Clerk.

Present: Senators Byrd, Nelson, and Gravel.

Senator BYRD. The hour of 2 o'clock having arrived, the committee will come to order.

The committee today will consider nine Senate tax bills and one House measure.

The Joint Committee on Taxation has prepared a description of these measures, which also provides revenue estimates and identifies the taxpayers affected by the proposals. This pamphlet, prepared by the joint committee, shall be included at this point in the record.

[The material referred to follows:]

INTRODUCTION

The bills described in this pamphlet have been scheduled for a hearing on June 24, 1980, by the Senate Finance Subcommittee on Taxation and Debt Management Generally. There is one bill that has been passed by the House of Representatives (H.R. 5391) and 10 Senate bills (S. 1614, S. 2075, S. 2493, S. 2547, S. 2646, S. 2660, S. 2757, S. 2766, S. 2783, and S. 2784) described in the pamphlet.

The first part of the pamphlet is a summary of the bills presented in bill numerical order. This is followed by a more detailed description of the bills, setting forth present law, the issues involved, an explanation of the bills, the effective dates, and the estimated revenue effects.

I. SUMMARY

1. H.R. 5391

Second Tier Tax Correction Act of 1980

Under present law, a two-tier excise tax system is applicable to private foundations, employee benefit trusts, and black lung benefit trusts, with respect to prohibited acts of these organizations. The second-tier excise tax is not imposed if the prohibited act is corrected within a correction period. The Tax Court has held that it lacks jurisdiction to redetermine a deficiency for a second-tier tax because the tax is not imposed until after its decision is final.

Under the bill, the second-tier excise tax would be imposed before any litigation begins (in order to insure that the Court will have jurisdiction) but would be forgiven if the prohibited act is corrected within a correction period.

2. S. 1614—Senator Bentsen

Local Newspaper Exemption From Foundation Business Holding Provisions

Under present law, private foundations are limited in their percentage ownership in a business enterprise. The bill would exempt holdings in an independent local newspaper business from these restrictions.

3. S. 2075—Senator Gravel

Definition of An Affiliated Group for Purposes of the Air Transportation Excise Taxes

Present law provides an exception from the air passenger ticket and air freight waybill excise taxes for air transportation provided by a member of an affiliated group of corporations to another member of the affiliated group, where the aircraft so used is not available for hire by persons who are not members of the affiliated group. The noncommercial aviation fuels taxes apply for fuel used in such instances.

The bill would expand the definition of an affiliated group to also include a tax-exempt labor organization and its tax-exempt trusts (and any wholly-owned corporations of such trusts) established for the sole and exclusive benefit of the members of such labor organization and their families and dependents.

4. S. 2493—Senator Glenn

Extension of Time for Payment of Manufacturers Excise Tax on Tires, Inner Tubes, and Tread Rubber

Under present law, an excise tax is imposed upon the sale of certain tires, inner tubes, and tread rubber by the manufacturer, producer, or importer. This tax generally is payable soon after such items are sold.

The bill would allow manufacturers, producers, and importers of taxable tires, inner tubes, and tread rubber to postpone payment of the excise tax upon the sale of items until 90 days after the last day of the month in which the item was sold.

5. S. 2547—Senators Gravel, Hatfield, Levin, and Hayakawa

Tax Exemption for Industrial Development Bonds for Beverage Container Facilities

Under present law, tax-exempt industrial development bonds (IDBs) may be used to provide solid waste disposal facilities. The term "solid waste" is defined by Treasury regulations to mean garbage, refuse or other discarded materials which have no market or other value at the place they are located.

Refillable beverage containers do not, in general, qualify as solid waste. As a result, tax-exempt financing is generally not available for facilities used in the collection and processing of such containers.

The bill would allow tax-exempt IDBs to be used to finance the acquisition of beverage container facilities for use in a State or locality that has enacted a law which requires a deposit on the bottles, discourages the sale of beverages in nonreturnable bottles, or prohibits or discourages the sale of beverages in metal container without nondetachable opening devices. The facilities that may be financed under the bill are:

(1) refillable beverage containers;

(2) property used in the collection, sorting or handling of beverage containers;

(3) property used in the cleaning and processing of refillable beverage containers; and

(4) property used for the manufacture of metal beverage container tops with nondetachable opening devices.

6. S. 2646—Senator Boren

Save America Savings Account Act of 1980

Under present law, an individual may exclude from gross income up to $200 ($400 on a joint return) of dividends and interest received in calendar years 1981 and 1982. (For 1980 and years after 1982, the exclusion is for up to $100 of dividends for each individual.)

The bill would allow an additional exclusion for qualified interest received on deposits held for not less than one year of up to $100,000 where the deposits are used to make loans for the purchase of owner-occupied residential property, the operation of a trade or business, or the operation of a farm for farming purposes. The rate of interest on the deposit may not exceed 7 percent and the rate of interest on the loan may not exceed the rate of interest on the deposit by more than 2½ percentage points.

7. S. 2660—Senator Moynihan

Tax Exemption for Industrial Development Bonds for Facilities for the Local Furnishing of Gas

Under present law, tax-exempt industrial development bonds (IDBs) may be used to provide facilities for the local furnishing of gas. Such a facility is defined as property for the furnishing of gas which is part of a system providing service to the general populace in a service area comprising no more than two contiguous counties. The bill would amend the definition of facilities for the local furnishing of gas to include property for the furnishing of gas which is part of a system providing service to the general populace in a service area comprised of a city and one contiguous county.

8. S. 2757—Senators Bentsen, Stevenson, Heinz, and Danforth

Taxation of Export Trading Companies

In the case of a Domestic International Sales Corporation (DISC) which is also an export trading company (as defined in the companion bill, the Export Trading Company Act of 1980 (S. 2718)), the bill would expand the definition of qualifying DISC income to include the export of certain U.S. services and the performance of services which facilitate the export of U.S. goods and services. The bill would also allow a banking organization which invests in the voting stock of an export trading company to qualify as a DISC.

Under present law, a subchapter S corporation may not have corporate shareholders and may not derive more than 80 percent of its gross receipts from foreign sources. Under the bill, a subchapter S corporation which is also an export trading company may have corporate shareholders as long as they qualify as subchapter S corporations. Also under the bill, such dual status corporations are exempt from the foreign income limitation.

9. S. 2766—Senator Gravel

Tax Exemption for Industrial Development Bonds for Facilities the Primary Purpose of Which Is the Generating of Hydroelectric Power

Under present law, tax-exempt industrial development bonds (IDBs) may be used to provide financing for the installation of electrical generating equipment at, and the rehabilitation of, an existing dam. Tax-exempt IDBs may also be used to provide financing for the installation of electrical generating equipment at a site which does not involve the impoundment of water. However, in order to qualify for tax-exempt financing, the facility must have an installed capacity of less than 125 megawatts, the facility must be owned for tax purposes by a State or local government, and the facility must satisfy the "public use" requirement.

The bill would allow tax-exempt IDBs to be used to provide facilities the primary purpose of which is the generating of hydroelectric power.

10. S. 2783—Senators Wallop and Garn

Definition of Shale Oil Equipment for the Energy Investment Credit

In addition to the generally applicable 10-percent investment tax credit, the Energy Tax Act of 1978 provided a 10-percent energy investment credit for shale oil equipment. The latter credit applies to equipment for producing or extracting shale oil from shale rock, but generally not to equipment for use in upgrading the extracted liquid.

The bill would expand the definition of shale oil equipment to include equipment used to upgrade shale oil.

S. 2784—Senator Gravel

Effective Date of the Energy Investment Credit for Coke Ovens

Under the Crude Oil Windfall Profit Tax Act of 1980, the 10-percent energy investment credit for alternative energy property was extended to equipment used to produce coke and coke gas for periods after December 31, 1979.

Under the bill, the credit for equipment used to produce coke and coke gas would apply retroactively with respect to periods after September 30, 1978 (the general effective date for the Energy Tax Act of 1978, under which the energy tax credit was enacted).

II. DESCRIPTION OF BILLS

1. H.R. 5391

Second Tier Tax Correction Act of 1980

Present law

Under present law, the Internal Revenue Code contains nine sections which impose a two-tier excise tax system to insure the compliance of private foundations[1] pension trusts[2] and black lung benefit trusts[3] with certain provisions of the Code. Under each of the sections, a first-tier excise tax is imposed automatically if the foundation or trust engages in a prohibited act (such as self dealing between a disqualified person and a private foundation), and a much larger second-tier excise tax is imposed for failing to correct the prohibited act within a "correction period." The "correction period" ends after the time a court decision as to whether the taxpayer is liable for the second-tier tax becomes final. This system is designed to provide an adequate opportunity for court review and correction of the transaction before the Internal Revenue Service can impose the second-tier tax. The second-tier taxes are intended to be sufficiently high to compel voluntary compliance (at least after court review) with these provisions.

In a recent case,[4] the Tax Court held that it lacked the authority to redetermine a deficiency of a second-tier tax with respect to an act of self dealing by a private foundation under Code section 4941(b). The Court found that because the second-tier tax is not "imposed" until after its decision is final, it did not have jurisdiction to redetermine a deficiency of that tax. In addition, the Court noted that the "amount involved" (upon which the amount of tax is based) cannot be determined until after the decision has become final.

Issue

The issue is whether the two-tier excise tax system for prohibited acts by private foundations, pension trusts, and black lung trusts should be amended in order to insure the courts have jurisdiction to enforce the second-tier taxes.

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[1] The provisions relating to private foundations are Code sections 4941 (self-dealing), 4942 (failure to distribute income), 4943 (excess business holdings), 4944 (jeopardy investments), and 4945 (taxable expenditures). These provisions were added by the Tax Reform Act of 1969.

[2] The provisions relating to pension trusts are Code sections 4971 (minimum funding) and 4975 (prohibited transactions). These provisions were added by the Employee Retirement Income Security Act of 1974.

[3] The provisions relating to black lung benefit trusts are Code sections 4951 (self-dealing) and 4952 (taxable expenditures). These provisions were added by the Black Lung Benefits Revenue Act of 1977.

[4] *Adams* v. *Commissioner*, 72 T.C. 81 (1979). This decision was followed in two subsequent cases: *Larchmont* v. *Commissioner*, 72 T.C. 131 (1979), and *H. Fort Flowers Foundation* v. *Comissioner*, 72 T.C. 399 (1979).

Explanation of the bill

Under the bill, the second-tier excise tax would be imposed at the end of the taxable period (i.e. the time the Internal Revenue Service mails a notice of deficiency to the taxpayer with respect to the first-tier tax or when the first-tier tax is assessed if no deficiency notice is mailed). However, the second-tier tax would not be assessed if the taxpayer files a petition with the Tax Court to redetermine that tax and the taxpayer corrects the prohibited act by the end of the correction period. Under the bill, the correction period would end when the decision of the Tax Court becomes final (under Code sec. 7481), except that it would be extended by any period the IRS determines is reasonable and necessary to bring about correction (Code sec. 4962(e)).

The bill also would provide for a supplemental proceeding by the Court to determine whether the taxpayer corrected the prohibited act within the correction period, if the Court previously determined that the second-tier tax was properly imposed.

Thus, where the taxpayer petitions the Tax Court to redetermine a second-tier tax, the tax would not be assessed unless the Court decides either in reviewing imposition of the tax, or in a supplemental proceeding on the timeliness of a correction, that the taxpayer has engaged in an act giving rise to a first-tier tax and that the act was not timely corrected.

In refund cases, the bill would suspend the collection of any second-tier excise tax which was assessed (for example, because a notice of deficiency was mailed and no petition was filed with the Tax Court) until the taxpayer completes its administrative and judicial refund procedures. Thus, a taxpayer may obtain U.S. district court or Court of Claims review of issues involving the second-tier tax without first being required to pay the second-tier tax.[5]

Finally, the bill would fix the amount of the second-tier taxes on self-dealing (Code sec. 4941, 4951, and 4975) on the date the second-tier tax is imposed.

(An identical bill, S. 2485, was introduced by Chairman Russell B. Long.)

Effective date

The bill would apply to second-tier taxes assessed after the date of enactment of the bill (except in cases where a court decision with respect to that tax is final on that date).

Revenue effect

The bill is not expected to have any effect on budget receipts.

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[5] Under Treasury regulations, the correction period is extended during the pendency of refund proceedings. Under Code section 7422(g)(1), the jurisdiction requirement that a taxpayer pay the second-tier tax is waived.

2. S. 1614—Senator Bentsen

Local Newspaper Exemption From Foundation Business Holdings Provision

Present Law

The Tax Reform Act of 1969 imposed an excise tax upon the excess business holdings of a private foundation (Code sec. 4943). Generally, under the excess business holdings provisions, the combined ownership of a business by a private foundation and all disqualified persons cannot exceed 20 percent of the voting stock of the business (35 percent if other persons have effective control of the business).

The 1969 Act provided that, if a private foundation and disqualified persons together had holdings on May 26, 1969, in excess of the permitted amounts under the general rules, then those holdings could be retained if they consisted of not more than 50 percent of the business. If the combined holdings exceeded 50 percent of the business on that date, then over a transitional period the combined holdings have to be reduced to 50 percent (ultimately to 35 percent if the disqualified persons hold, in the aggregate, no more than 2 percent of the business; if they hold more than 2 percent, then the combined holdings may continue to be as much as 50 percent, of which the foundation itself may hold no more than 25 percent).

Issue

The issue is whether ownership by a private foundation in an independent local newspaper business should be exempted from the excess business holdings provision of present law.

Explanation of the bill

The bill provides that an independent local newspaper business would not be treated as a business enterprise for purposes of the excess business holdings provision (Code sec. 4943). Thus, there would be no limitation on the percentage interest in such an enterprise that a foundation may own.

An independent local newspaper business means a business (whether organized as a corporation, partnership, or proprietorship), no interests in which are traded in an established securities market, which publishes an independent local newspaper. An "independent local newspaper" is defined as a newspaper publication which is not a member of a "chain of newspaper publications" and which has all of its publishing offices in a single city, community or metropolitan area, or, as of January 1, 1979, within one State. A "chain of newspaper publications" is defined as two or more newspaper publications under common control on January 1, 1979, and which are not published in a single city, community, or metropolitan area.

The principal beneficiary of this bill is Houston Endowment, Inc., which owns the Houston Chronicle. However, it is expected that other taxpayers owning newspapers would benefit from enactment of the bill.

Effective date

The bill would apply to taxable years ending after the date of enactment of the bill.

Revenue effect

It is estimated that the bill would reduce income tax liability by $10 million per year. After approximately five years, it is estimated that the bll would reduce estate tax liability by $100 million per year. There would be a negligible impact in fiscal year 1981.

3. S. 2075—Senator Gravel

Definition of an Affiliated Group for Purposes of the Air Transportation Excise Taxes

Present law

The excise taxes on air passenger tickets (under Code sec. 4261)[1] and air freight waybills (under Code sec. 4271)[2] apply to commercial aviation, that is, as a business of transporting persons or property for compensation or hire by air.

Code sections 4281 and 4282 provide two exceptions to the air passenger and air freight taxes. Code section 4281 provides that the taxes do not apply to transportation by an aircraft having a maximum take-off weight of 6,000 pounds or less, except when the aircraft is operated on an established line. Code section 4282 provides for an exception for certain air transportation provided for other members of an affiliated group. This exception is applicable for air transportation provided by a member of an affiliated group[3] to another member of the affiliated group where the aircraft so used is not available for hire by persons who are not members of the affiliated group.

The aviation fuels taxes for noncommercial aviation (under Code sec. 4041(c)) apply in such instances where the transportation taxes do not apply.

Issue

The issue is whether the affiliated group exception from the air transportation excise taxes for controlled corporations should be expanded to include a tax-exempt labor organization and exempt trusts (or corporations owned by the trust) established for the sole and exclusive benefit of the members of such labor organizations and their families and dependents.

Explanation of the bill

The bill would expand the affiliated group exception from the air transportation excise taxes for controlled corporations to also include tax-exempt labor organizations (under Code sec. 501) and their tax-exempt trusts (and any wholly-owned corporations of such trusts) established for the sole and exclusive benefit of the members of such labor organization and their families and dependents.

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[1] The air passenger ticket tax presently is 8 percent through June 30, 1980, and 5 percent beginning on July 1, 1980. However, legislation is currently pending (H.R. 7477 as passed by the House of Representatives on June 17, 1980) to extend the 8-percent rate through September 30, 1980. The Finance Committee, on June 10, 1980, approved the substance of the 3-month extension. In addition, a Ways and Means Committee amendment, to be offered to H.R. 6721, would extend the 8-percent rate through September 30, 1982, and at 5 percent thereafter.

[2] The air freight waybill tax presently is 5 percent through June 30, 1980, and is scheduled to expire on July 1, 1980. However, H.R. 7477 would extend the present 5-percent tax through September 30, 1980. In addition, the Ways and Means Committee amendment to H.R. 6721 would extend the 5-percent tax through September 30, 1985.

[3] "Affiliated group" is a group of corporations connected through common stock ownership (as defined in Code sec. 1504(a), except that, for purposes of the transportation tax exception, all such corporations are treated as the includible corporation, without any exclusion under Code sec. 1504(b)).

Effective date

The bill would be effective upon the date of enactment.

Revenue effect

This bill is estimated to have an insignificant revenue effect.

4. S. 2493—Senator Glenn

Extension of Time for Paying Excise Tax on Tires, Inner Tubes, and Tread Rubber

Present law

Under present law, a manufacturers excise tax is imposed upon the sale of certain tires, inner tubes and tread rubber (Code sec. 4071).

Under Code section 6302(a), the mode and time for collecting all manufacturers excise taxes is established by Treasury Regulations. Under the regulations generally applicable to the payment of manufacturers excise taxes (Treas. Regs. sec. 48.6302(c)-1), if an individual's liability for taxes reportable on a quarterly excise tax return (Form 720) exceeds $100 for any calendar month (other than the last month of a calendar quarter), then the amount of such liability must be deposited at an authorized depository, or at the Federal Reserve Bank serving the area in which the individual is located, on or before the last day of the month following the month for which the liability exceeds $100. In the case of the last month of a calendar quarter (and where the taxes for the quarter are less than $100), the taxes must be paid by the last day of the month following the close of the calendar quarter.

If an individual's liability for taxes reportable on a quarterly excise tax return exceeded $2,000 for any month in the preceding calendar quarter, then taxes for the following quarter (regardless of amount) must be deposited on a semi-monthly basis. Taxes which are payable semi-monthly must be deposited by the 9th day following the semi-monthly period to which the taxes relate. Generally, a semi-monthly period means the first 15 days of a calendar month or the portion of a calendar month following the 15th day of the month. Thus, taxes for the first 15 days of a calendar month must be paid by the 24th of that month, and taxes for the period after the 15th of a calendar month must be paid by the 9th of the following month.

In addition, if the semi-monthly period is within either of the first two months of the quarter, any underpayment of excise taxes for a month must be deposited by the 9th day of the second month following the month of the underpayment. Underpayments in the third month of the quarter must be deposited by the end of the first month after the end of the quarter.

The regulations contain no special rules to defer payment of the excise tax with respect to items sold on credit. However, Code section 4216(c) provides that, in the case of an installment sale and title does not pass until some future date, the tax is paid as installments are received.

Issue

The issue is whether the payment of the manufacturers excise tax on tires, inner tubes, and tread rubber should be delayed until 90 days after the end of the month in which the item is sold, i.e., for up to 4 months after a sale of and payment for the article.

pages tightly bound

Explanation of the bill

The bill would eliminate the Secretary's general regulatory authority, under Code section 6302(a), as to the payment of the excise tax imposed on tires, inner tubes, and tread rubber, by providing that such tax is payable 90 days after the last day of the month in which the manufacturer, producer, or importer sells taxable articles.

Effective date

The provisions of the bill would apply to tires, inner tubes, and tread rubber sold on or after the first month beginning after the date of enactment.

Revenue effect

It is estimated that this bill would reduce budget receipts by $190 million in fiscal year 1981 and by less than $5 million annually thereafter. (The fiscal year 1981 estimate is based on the assumption that this bill would be enacted after August 31, 1980.)

5. S. 2547—Senators Gravel, Hatfield, Levin, and Hayakawa

Tax Exemption for Industrial Development Bonds for Beverag Container Facilities

Present law

Under present law, interest on State and local government obligations is generally exempt from Federal income tax. However, since 1968, tax exemption has been denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

An exception to the denial of tax exemption for interest on IDBs applies in the case of IDBs which are used to provide solid waste disposal facilities. Solid waste disposal facilities are defined in Treasury regulations as property used for the collection, storage, treatment, utilization, processing, or final disposal of solid waste. A facility which disposes of solid waste by reconstituting, converting, or otherwise recycling it into material which is not solid waste will qualify as a solid waste disposal facility if 65 percent of the material introduced into the recycling process is solid waste (Treas. Reg. sec. 1.103-(f)(2)(ii)).

The Internal Revenue Code does not define the term "solid waste." However, the legislative history of the IDB exception for solid waste disposal facilities indicates that the term has the same meaning as it had in the Solid Waste Disposal Act. In that Act, solid waste was defined as "garbage, refuse, and other discarded solid materials." The legislative history of that Act states that "solid wastes include a great variety of things that individuals, manufacturers, commercial establishments, and communities discards as no longer useable."

The Treasury Regulations, which define the term "solid waste", provide that solid waste means garbage, refuse, and other discarded materials so long as it is property which is useless, unused, unwanted, or discarded solid material which has no market or other value at the place it is located (Treas. Reg. sec. 1.103–8(f)(2)(ii)).

As a result of the existing definition of the term "solid waste", facilities used in connection with returnable beverage containers will not, in general, qualify as solid waste disposal facilities.

Issue

The issue is whether tax-exempt IDBs should be allowed to be used to finance the acquisition of refillable beverage containers, property used in the collection, sorting, or handling of beverage containers, property used in the cleaning and processing of refillable beverage containers, and property used for the manufacture of metal beverage container tops with nondetachable openings in States or localities which prohibit or discourage the use of nonreturnable bottles or metal containers without nondetachable opening devices.

Explanation of the bill

The bill provides that interest on IDBs used to provide qualified beverage container facilities would be exempt from Federal income taxation. Beverage container facilities covered by the bill are: (1) the initial supply of refillable beverage containers and shells and (2) any facility used by a distributor or bottler of beverages (a) in the collection, sorting, or handling of beverage containers,[1] (b) in the cleaning and processing of refillable beverage containers, or (c) for the manufacture of metal beverage container tops with nondetachable opening devices.

A beverage container facility would be treated as a qualified beverage container facility where three requirements are met. First, the construction, reconstruction, erection, or acquisition of the facility must occur during the two-year period beginning on the effective date of a "beverage container law." Second, the facility must not replace an existing beverage container facility. Finally, the facility must be used in connection with a "beverage container law."

The bill defines a "beverage container law" as a law which (1) requires the purchaser of beverages sold in containers to pay a deposit or fee to the seller in connection with the purchase of such beverages, (2) prohibits or discourages the sale of beverages in nonreturnable containers, or (3) prohibits or discourages the sale of beverages in metal containers unless the containers have nondetachable opening devices.

Effective date

The bill would apply to obligations issued after December 31, 1979. In addition, the bill would allow the refinancing of existing conventionally financed beverage container facilities where (1) a bond resolution was adopted or other similar official action was taken by the issuer prior to the commencement of the construction, erection, or acquisition of the facility, and (2) the obligations are issued no later than one year after the date of enactment.

Revenue effect

It is estimated that this bill would reduce budget receipts by $10 million in fiscal year 1981, $20 million in 1982, $40 million in 1983, $60 million in 1984, and $70 million in 1985.

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[1] This provision apparently is not restricted solely to refillable beverage containers. Thus, tax-exempt financing may be available under the bill with respect to this type of equipment which is used in conjunction with "throw-away" bottles and cans.

6. S. 2646—Senator Boren

Save America Savings Account Act of 1980

Present law

In calendar years 1981 and 1982, an individual may exclude from gross income up to $200 of dividend and interest income ($400 on a joint return) (Code sec. 116). The exclusion for dividends, which has been in the Code since 1954, generally applies to dividends paid by domestic corporations.[1] The exclusion for interest was enacted in the Crude Oil Windfall Profit Tax Act of 1980 and applies generally to most domestic sources of interest income.

Issue

The issue is whether an additional exclusion from gross income should be provided for interest received on deposits which are used to make loans for specifically designated purposes (i.e., for home ownership, trade or business, or farming purposes) where the rate of interest on the deposit does not exceed a designated amount (i.e., 7 percent) and the lower interest rate is flowed through to the borrower.

Explanation of the bill

Under the bill, amounts received as qualified interest for the taxable year would be excluded from gross income. The exclusion would not apply to interest income received with respect to amounts on deposit in excess of $100,000 for the taxable year. The amounts excluded from gross income under this proposal would be in addition to any amounts excludable under present law (Code sec. 116).

Qualified interest is defined as interest which is paid at a rate of 7 percent or less, but only if the principal on which the interest is earned (1) is held on deposit for not less than 1 year and (2) is used for the purpose of making qualified loans.

A qualified loan is a loan made for (1) the purchase of owner-occupied residential property, (2) the operation of a trade or business, or (3) the operation of a farm for farming purposes. The rate of interest payable on a qualified loan could not be more than 2½ percentage points above the rate of interest paid on the deposits from which the loan is made.

A qualified loan is not a loan used, in whole or in part, for the purchase of land, other than for the purchase of owner-occupied residential property.

Effective date

The bill would apply with respect to taxable years beginning after December 31, 1979.

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[1] For 1980 and years after 1982, the general exclusion is for up to $100 of dividends received by an individual. Married couples filing joint returns may exclude up to $200 of dividends (up to $100 for each person).

Revenue effect

It is estimated that the bill would reduce calendar year liability and fiscal year receipts as follows:

(Millions of dollars)

	1980	1981	1982	1983	1984	1985
Calendar	10, 360	11, 603	12, 996	14, 555	16, 302	18, 258
Fiscal	(1)	12, 100	12, 787	14, 438	16, 302	17, 036

[1] Less than $5 million.

7. S. 2660—Senator Moynihan

Tax Exemption for Industrial Development Bonds for Facilities for the Local Furnishing of Gas

Present law

Under present law, interest on State and local government obligations is generally exempt from Federal income tax. However, since 1968, tax exemption has been denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

An exception to the denial of tax exemption for Interest on IDBs applies in the case of IDBs which are used to provide exempt activity facilities. Such facilities include facilities for the local furnishing of electric energy and gas (Code sec. 103(b)(4)(E)).

A facility for the furnishing of electric energy or gas is defined in Treasury regulations as property for the furnishing of electric energy or gas which is part of a system providing service to the general populace in a service area comprising no more than two contiguous counties. (Treas. Reg. sec. 1.103–8(f)(2)(iii)). In the Revenue Act of 1978, the definition of a facility for the local furnishing of electric energy was modified to also include property for the furnishing of electric energy which is part of a system which provides electric energy to the general populace in a service area comprising no more than a city and one contiguous county.

Issue

The issue is whether the definition of a facility for the local furnishing of gas should be amended to include a facility for the furnishing of gas which is part of a system which provides service to the general populace in an area comprising no more than two contiguous counties or a city and one contiguous county.

Explanation of the bill

The bill provides that the local furnishing of gas from a facility would include the furnishing solely within the area comprising of a city and one contiguous county. Under the bill, tax-exempt financing would be made available in the case of a facility for the furnishing of gas (which otherwise meets the requirements of Code sec. 103) provided that the service area of the facility comprised no more than two contiguous counties or a county and one contiguous city.

The principal beneficiaries of the bill would be the Brooklyn Union Gas Company and the Consolidated Edison Corporation.

Effective date

The bill would apply to obligations issued after the date of enactment.

Revenue effect

It is estimated that this bill would reduce budget receipts by $2 million in fiscal year 1981, $4 million in 1982, $8 million in 1983, $11 million in 1984, and $14 million in 1985.

8. S. 2757—Senators Bentsen, Stevenson, Heinz, and Danforth

Taxation of Export Trading Companies

Present law

Domestic International Sales Corporation (DISC)

Under present law, a DISC is allowed to defer an incremental portion of its export income. This export income includes sales, investment, and services income which result from certain defined export operations of the DISC. With respect to services, this deferrable export income can be for: (1) services related and subsidiary to the sale or other disposition of export property by the DISC, (2) engineering or architectural services for foreign construction projects, or (3) managerial services which further the production of export receipts for the DISC. Income from other services, irrespective of its relationship to export income, is not deferrable export income under the DISC provisions.

Under present law, not all corporations are eligible to be treated as DISCs. Financial institutions, including banks and organizations carrying on banking activities, are not eligible to be DISCs.

Subchapter S corporations

In order for a corporation to qualify as a subchapter S corporation, it must meet several criteria. One of these criteria is that the subchapter S corporation may not have any corporate shareholders during the taxable year. If any of the subchapter S corporation's stock is acquired by a corporation during the taxable year, its subchapter S status is terminated for that year and all future years. However, in the fifth year (or earlier year if the Commissioner consents) following the year of termination, the corporation may re-elect subchapter S status if it meets the eligibility requirements for such year.

Another subchapter S requirement that must be met under present law is that the corporation cannot have more than 80 percent of its gross receipts from foreign sources. Failure to meet this requirement will also result in termination of Subchapter S status.

Background

This bill contains the tax provisions that relate to the companion bill, the Export Trading Company Act of 1980 (S. 2718), which was reported (S. Rept. No. 96–735) by the Senate Committee on Banking, Housing and Urban Affairs on May 15, 1980. The Act is intended to increase U.S. exports of products and services by encouraging export trade services to U.S. producers and suppliers. The Act states that, if exporters are to be successful in promoting U.S. exports, they must be able to draw on the resources, expertise, and knowledge of the U.S. banking system. The principal means by which the bill (S. 2718) attempts to accomplish this end is to amend the banking laws of the United States to allow banks to hold voting stock in an export trading company.

Issues

The issues presented by this bill are:

(1) Whether a banking organization which invests in an export trading company should be allowed to be a DISC;

(2) Whether the category of deferrable DISC income should be expanded to include income from the export of certain U.S. services and the performance of services which facilitate the export of U.S. goods and services;

(3) Whether subchapter S corporations which also qualify as export trading companies should be exempt from the requirements that subchapter S corporations may not have corporate shareholders and cannot have more than 80 percent of their gross receipts from foreign sources.

Explanation of the bill

Domestic International Sales Corporation

In the case of a corporation which is both a DISC and an export trading company,[1] the bill expands the category of deferrable DISC income to include the export of "services produced in the United States" and "export trade services". "Services produced in the United States" are defined in the companion bill (sec. 103(a)(3)) as consulting, management, amusement, etc., services where at least half of the income is attributable to U.S. citizens or is otherwise attributable to the United States. "Export trade services" are defined in the companion bill (sec. 103(a)(4)) as consulting, marketing, financing, etc., activities which facilitate the export of goods or services produced in the United States. Essentially, the bill would allow most, if not all, of the export related activities and services of the dual status corporation to be treated as deferrable DISC income, even if the activities or services are performed in the United States.

The bill would also allow a banking organization which invests in the voting stock of an export trading company to be eligible to be treated as a DISC. The export financing activities of such an organization could qualify as deferrable DISC income. (The expansion of the DISC provisions to include banks and income from banking activities is intended to augment the provisions of the companion bill, S. 2718, which attempts to make banking facilities more available to export trading companies in order to increase their export operations.)

The bill also directs the Secretary of Commerce to prepare and disseminate information to exporters on the advantages and disadvantages of establishing a DISC.

Subchapter S corporations

The bill would allow an export trading company with corporate shareholders to qualify as a subchapter S corporation as long as the corporate shareholders are also subchapter S corporations.

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[1] Under the companion bill (S. 2718), an export trading company includes any corporation which exports or facilitates the export of U.S. goods and services.

Also, for corporations that are both subchapter S corporations and export trading companies, the bill eliminates the requirement that a subchapter S corporation cannot have more than 80 percent of its gross receipts from foreign sources. (This is intended to allow such a dual status corporation to maximize its export activities without jeopardizing its subchapter S status.)

Effective date

The provisions of the bill would apply to taxable years beginning after December 31, 1980.

Revenue effect

The Department of Treasury has estimated that the bill would reduce calendar year 1981 liabilities by $300 to $700 million.

9. S. 2766—Senator Gravel

Tax Exemption for Industrial Development Bonds for Facilities the Primary Purpose of Which is the Generating of Hydroelectric Power

Present law

Under present law, interest on State and local government obligations is generally exempt from Federal income tax. However, since 1968, tax exemption has been denied to State and local government issues of industrial development bonds (IDBs). A State or local government bond is an IDB if (1) all or a major portion of the proceeds of the issue are to be used in any trade or business of a person other than a State or local government or tax-exempt organization, and (2) payment of principal or interest is secured by an interest in, or derived from payments with respect to, property or borrowed money used in a trade or business.

An exception to the denial of tax exemption for interest of IDBs applies in the case of IDBs which are used to provide exempt activity facilities. Such facilities include qualified hydroelectric generating facilities (Code sec. 103(b)(4)(H)).

Under this provision, tax-exempt IDBs may be used to provide (1) equipment for generating electric energy from water, and (2) structures for housing such equipment, fish passageways, and dam rehabilitation property, where four conditions are satisfied. First, such facilities must be owned for tax purposes by a State or local governmental unit. Second, such facilities must be located at the site of an existing dam or at a site which does not involve the impoundment of water. Third, the installed generating capacity of the generating equipment may not exceed 125 megawatts. Finally, the output of the facility must be available for use by members of the general public. In the case of a facility with an installed capacity of more than 25 megawatts but less than 125 megawatts, only a portion of the cost of the facility may be provided with tax-exempt IDBs.

The exception for qualified hydroelectric generating facilities was enacted as part of the Crude Oil Windfall Profit Tax Act of 1980. That Act, as originally passed by the Senate, would have allowed the use of tax-exempt financing for facilities the primary function of which is the generating of hydroelectric power, except for existing facilities whose construction began before October 25, 1979, and whose installed capacity is more than 25 megawatts. Thus, the Senate version of the Act would have allowed tax-exempt financing for all new hydroelectric dams, for the installation of qualifying property at and the rehabilitation of existing dams which would have an installed generating capacity of less than 25 megawatts, and for qualifying property at a site which did not involve the impoundment of water. The Senate amendment did not, however, allow the use of tax-exempt financing for "pumped storage" facilities. In the conference on that Act, the provisions of the Senate amendment dealing with new dams were deleted.

Issue

The issue is whether tax-exempt IDBs should be allowed to be used to finance all hydroelectric generating facilities.

Explanation of the bill

The bill provides that interest on IDBs used to provide facilities the primary purpose of which is the generation of hydroelectric power would be exempt from Federal income taxation.

(It is understood that the sponsor of the bill intends that the hydroelectric facilities covered by the bill would automatically meet the public purpose requirement whether or not the output of the facility is made available for use by members of the general public.)

Effective date

The bill would apply to obligations issued after the date of enactment.

Revenue effect

It is estimated that this bill would reduce budget receipts by $20 million in fiscal year 1981, $40 million in 1982, $70 million in 1983, $100 million in 1984, and $140 million in 1985. (This assumes that "pumped storage" facilities are not covered by the bill.)

10. S. 2783—Senators Wallop and Garn

Definition of Shale Oil Equipment for the Energy Investment Credit

Present law

In addition to the generally applicable 10-percent investment tax credit, the Energy Tax Act of 1978 provided a 10-percent energy investment credit for shale oil equipment (Code sec. 48(l)(7)). The latter credit is generally available for property placed in service and expenditures incurred through December 31, 1982. In addition, the energy investment credit for shale oil equipment is available after 1982 and before 1991 where the following specified affirmative commitments are undertaken with respect to qualified property that involves long-term projects: (1) all engineering studies for the project have been completed, and all Federal, State, and local environmental and construction permits have been applied for, prior to 1983 and (2) binding contracts have been made prior to 1986 to acquire or construct at least 50 percent of all equipment that is designed especially for the project (Code sec. 46(a)(2)(C)(iii)).

The term "shale oil equipment" means equipment for producing or extracting kerogen from oil shale. (Kerogen is the liquid hydrocarbon extracted from sedimentary rock known as oil shale, and is referred to as shale oil.) The term "shale oil equipment" does not include equipment for hydrogeneration, refining, or other processes subsequent to retorting. (Retorting is the process of extracting kerogen from oil shale; hydrogenation is a post-retort process, whereby pressurized kerogen reacts with hydrogen gas in the presence of a catalyst for the purpose of purifying the kerogen. Prior to hydrogenation, shale oil is a viscous, and frequently impure, liquid. As such, it generally is not of pipeline quality.) Shale oil equipment includes such equipment involved in either surface or *in situ* processes. In the latter instance, shale oil equipment includes that used to create the underground cavity. In either case, equipment for supplying water, and for treating and handling spent shale rock, is included in the definition of shale oil equipment.

Also, under present law, a deduction for percentage depletion is allowed for 15 percent of the gross income from the extraction of oil shale. For this purpose, gross income includes any increment in value through the retorting stage, but does not include any increment in value attributable to hydrogenation, refining, or any other process subsequent to retorting (Code secs. 613(b)(2)(b) and (c)(4)(H)).

Issue

The issue is whether the definition of shale oil equipment which is eligible for the additional energy investment credit should be extended to include property used for hydrogenation (or similar processes) subsequent to retorting.

Explanation of the bill

The bill would extend the definition of shale oil equipment for purposes of the energy investment credit to include equipment used in hydrogenation or similar processes subsequent to retorting. However, the bill would not expand the definition of shale oil equipment to equipment used to refine shale oil.

Effective date

The bill would apply to periods after December 31, 1980.

Revenue effect

It is estimated that this bill would reduce fiscal year budget receipts by less than $5 million in 1981, $9 million in 1982, $31 million in 1983, $52 million in 1984, and $72 million in 1985.

Prior Congressional consideration

During the 94th Congress, Title XX of the Tax Reform Act of 1976, as reported by the Senate Finance Committee and passed by the Senate (S. Rept. No. 94–938, 94th Cong., 2d Sess. 568–569 (1976)), and H.R. 6860, as reported by the Senate Finance Committee, would have allowed an increased investment credit of 12 percent for shale oil conversion equipment. The credit would have applied to equipment for purifying kerogen. Title XX was not included in the Tax Reform Act of 1976.

11. S. 2784—Senator Gravel

Effective Date of the Energy Investment Credit for Coke Ovens

Present law

The Energy Tax Act of 1978 provided an additional 10-percent investment credit for certain alternative energy property effective for periods after September 30, 1978. As enacted, that Act specifically excluded oil and gas equipment, including that equipment used to produce coke or coke gas, from the new energy investment credit. However, in the consideration of that Act, an amendment was added on the Senate floor that would have allowed the energy investment credit for this type of equipment. This amendment was deleted from the Act by the Conference Committee.

The Crude Oil Windfall Profit Tax of 1980 made equipment used to produce coke or coke gas eligible for the energy investment credit. This extension was effective for periods after December 31, 1979. The extension covers expenditures for new coke ovens and costs incurred in the reconstruction or rehabilitation of existing coke ovens to produce coke and coke gas for use as a fuel or feedstock. In addition, qualifying equipment includes required pollution control equipment and related on site equipment to handle, store, and prepare coal for use in coke ovens.

Issue

The issue is whether the energy investment credit for coke ovens and related expenditures should be available with respect to qualifying investments made after September 30, 1978 and before 1980.

Explanation of the bill

The bill would make the provisions contained in the Crude Oil Windfall Profit Tax Act of 1980 with respect to coke ovens and related expenditures effective for qualifying investments made after September 30, 1978. This is the effective date applicable to the energy credit for alternative energy property investments under the Energy Tax Act of 1978.

Effective date

The change in the eective date would become effective on the date of enactment.

Revenue effect

It is estimated that the bill will reduce budget receipts by $50 million in fiscal year 1981, $3 million in 1982, and an insignificant amount thereafter. (This estimate assumes enactment after September 15, 1980.)

Senator **Byrd**. Now, I will list the bills by number. S. 1614, introduced by Senator Bentsen; S. 2075, introduced by Senator Gravel; S. 2493, introduced by Senator Glenn; S. 2547, introduced by Senator Gravel; S. 2646, introduced by Senator Boren; S. 2660, introduced by Senator Moynihan; S. 2557, introduced by Senators Bensten, Danforth, Heinz, and Stevenson; S. 2766, introduced by Senator Gravel; S. 2783, introduced by Senators Wallop and Garn; S. 2784, introduced by Senator Gravel, and H.R. 5391 and S. 2485, the latter being introduced by Senator Long.

Senator Glenn was listed to testify at this point. He is not here. I note that the Senator from Illinois, Mr. Stevenson, is present.

Senator Stevenson, would you want to present your comments at this point?

STATEMENT OF HON. ADLAI E. STEVENSON, A U.S. SENATOR FROM THE STATE OF ILLINOIS

Senator **Stevenson**. Thank you, Mr. Chairman.

I will be brief. May I submit my full statement for your record?

Senator **Byrd**. Yes. It will be included in the record, Senator Stevenson.

Senator **Stevenson**. Mr. Chairman, the Congress has come, I believe, to recognize that the continuing deep trade deficit of the United States is both a reflection and a cause of its decline as a great industrial power, and of continuing inflation, rising unemployment and recession.

Consequently, the Senate Banking Committee has reported legislation which would facilitate the creation of trading companies. Other nations have them. These trading companies could help to assure the representation of all products of all American companies in all parts of the world, including small companies which all too often nowadays are not involved in trade.

This legislation, which has the support of many of our colleagues, the President's Export Council, the administration, and other organizations, includes two tax provisions, and it would be my intention if we can get this bill brought up on the floor to strike those provisions so that the bill can move ahead.

Senator **Byrd**. Excuse me. Is this S. 2757?

Senator **Stevenson**. Well, I am coming to that, Mr. Chairman. Yes, that is what I am here to testify on. But the tax provisions which I would strike from the trading company legislation have been introduced separately as S. 2757, and it is our hope that if struck from the export trading company legislation, which is S. 2718, that this committee could act soon and favorably on S. 2757, which has been introduced by Senator Bentsen as well as other members of this committee.

We feel that those tax provisions are critical to the success of this whole endeavor, namely, the creation of great American trading companies.

In brief, they would make the trading companies, companies organized principally for exporting, for trade, eligible for DISC provisions, including exports of services, and also for subchapter S treatment, and both of those provisions are, as I say, in our opinion, important to the success of American trading companies.

They would provide financial incentives and help companies to absorb the original start-up costs which we anticipate for these trading companies.

Trading companies have been extremely successful in other countries. There is no reason they couldn't be equally successful in the United States. Our failure to encourage them puts us at a severe disadvantage in a very competitive world.

With trading companies, the increased exports and therefore the increased profitability of American companies should mean increased revenues for the Federal Government, and so, in time, the net effect for the budget should be a positive one.

We would be very grateful for your sympathetic consideration for these provisions which now, as I say, are in S. 2757, before this committee.

Senator **Byrd**. Thank you very much, Senator Stevenson.

I take it that the current DISC provisions do not permit the development of export trading companies.

Senator **Stevenson**. You are correct, basically for the reason that we envision exports of services. This is increasingly a service oriented economy. We have services to export. We feel that these services should be eligible for DISC treatment, as well as the services which the trade companies can render to exporters. We also want to insure that export trading companies with bank investors are not disqualified from DISC benefits.

Those are the two main reasons why we feel that the DISC provisions need to be modified.

Senator **Byrd**. Thank you, Senator Stevenson.

There is a rollcall in progress on the Afghanistan resolution, so you and I had best leave at this point. The committee will stand in recess temporarily.

Senator **Stevenson**. Thank you, sir.

[The prepared statement of Senator Stevenson follows:]

June 24, 1980

TESTIMONY OF SENATOR ADLAI E. STEVENSON BEFORE THE SENATE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

In January 1978, the Senate Subcommittee on International Finance commenced a year-long study of U.S. export policy. The conditions which prompted that study -- a rapidly mounting trade deficit and the declining competitiveness of U.S. industry in international and domestic markets -- are more apparent today. The merchandise trade deficit has soared to an annual rate of more than $40 billion. U.S. goods and services represent an ever smaller share of the world market.

The report issued by the Subcommittee recommended a number of measures to improve U.S. competitiveness abroad. These recommendations included the establishment of export trading companies which would provide a broad range of export services to U.S. producers, thus linking potential U.S. exporters with overseas markets. The Subcommittee also recommended the use of tax incentives, such as expanding the export benefits of DISC, to enable U.S. producers to compete with their foreign competitors in the world market.

S. 2757, which amends the subchapter S and DISC provisions of the Internal Revenue Code, represents an important step in providing such incentives to export trading companies. Under the bill, the subchapter S provisions of the Code would be amended to except export trading companies from the requirement that at least 20 percent of annual income be derived from sources within the U.S. and that all shareholders of a corporation electing subchapter S treatment be individuals. (The trading company must, however, otherwise be eligible for subchapter S treatment.) This would enable export trading companies to pass through initial start up losses to their shareholders.

The amendments to the DISC provisions of the Code will insure that bank investments in export trading companies will not disqualify these companies from using DISC's.

In addition, receipts from the export of services produced in the U.S. and export trade services would be eligible for DISC treatment as qualified export receipts.

It is not the intent of this bill to expand DISC benefits for income from the export of goods and services by captive trading companies. Thus, in order to qualify for these benefits, an entity must be organized and operated principally for the purposes of exporting goods and services produced in the United States and facilitating the exportation of goods and services by unaffiliated persons.

Treasury has indicated that it is difficult to estimate the revenue cost of extending DISC benefits to the "services produced in the United States" and "export trade services" of these DISC's. However, given the limitations imposed on eligible export receipts, the actual revenue cost is likely to be relatively modest. Moreover, it is important to take into account offsetting revenues which would be generated by increasing the incentives to export products and services of unaffiliated entities. If this measure succeeds in its objective, the net effect on revenues will be positive. More important, the competitiveness of U.S. goods and services in the world market will be greatly improved.

[Whereupon, a brief recess was taken.]

Senator **Byrd**. The committee will come to order.

Senator Boren, would you like to present your proposal now?

STATEMENT OF HON. DAVID L. BOREN, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

Senator **Boren**. Thank you very much, Mr. Chairman.

I appreciate the opportunity to appear before you, and I might ask consent that I just hit the highlights of my testimony and submit the rest for the record, to conserve your time.

Senator **Byrd**. Very good, sir.

Senator **Boren**. As the chairman knows, he and I have shared a deep concern over the state of the economy in this country for many months. I first stated that concern in a speech on the floor of the Senate in April. At that time, the prime interest rate had hit close to 20 percent. Individual savings were at the lowest in 30 years, and the rate of savings in the United States significantly trailed other major industrialized countries of the world.

Again in the month of May I pointed with alarm at the statistics which showed an ever declining economy. On May 2, the Commerce Department had reported that the leading economic indicators had plunged 2.6 percent in March, the most in 5 years, and the third largest decline in the history of the Consumer Price Index.

The Department also reported that new orders flowing to the Nation's factories fell by one-tenth of 1 percent in March, the largest drop in 8 months. Federal forecasters were expressing publicly doubts that the consumer price increases would slow by the summer, and that this year's retail climb could top 14 percent, which would far outstrip the officially estimated 12.8 percent.

Mr. Chairman, it is now the 24th of June, and if one were to scan the headlines of the economic reporting services of this country, there might be some occasion for slightly rising optimism. For example, one national publication headlined an article yesterday saying that the grip of the recession could be easing, and those who want to see improvement by searching somewhat diligently seem to be able to find it in recent days.

Morgan Guaranty Trust has lowered the prime rate to 11.5 percent. Several savings and loan associations have dropped the home loan rates to 12 percent.

The word comes increasingly from sources from within the administration that some sort of tax cut may be attempted this year.

But let us not be fooled. Let us not believe that the road to recovery is in fact before us. Behind the optimistic headlines, there is still the grim reality of an economy in very serious trouble.

Last Friday, the Commerce Department reported that new factory orders for durable goods fell, as seasonally adjusted, 7.3 percent, the fourth consecutive monthly decline. Earlier this week came the report that personal income had increased by a very, very small amount in May after declining a like amount in the previous month.

To top off the discouraging news of last week, the Commerce Department's preliminary estimate was that economic output is dropping at an unusually sharp 8.5 percent annual rate in the current quarter, and this, of course, is the second sharpest quarterly decline since the depression.

I mention these things as a counterbalance to the optimistic news that may well come today as the administration releases their latest set of economic indicators. We are not out of the woods. We have serious problems that demand action.

I believe that S. 2646, which we have entitled the Save America Savings Account Act of 1980, is a framework within which we can construct a solid response to the economic problems which I have outlined. This bill will provide a needed safety net.

It proposes the establishment of a special tax-exempt Save America Savings Account to create a pool of money which could be loaned by financial institutions to farmers, small businessmen, and prospective homeowners.

These accounts would be offered through local banks and financial institutions, and would pay 7 percent interest. An individual could place no more than $100,000 in such accounts. These accounts would be attractive, Mr. Chairman, I think, because in many cases 7 percent return tax-free would give the saver more than a 14 percent return, for example, on which a tax is levied, of course, depending upon the tax rate of the individual saver involved.

In return, the banks and financial institutions which offer these tax exempt lower interest savings accounts would agree to loan the deposits in these accounts at not more than 9.5 percent interest, to be used for operating and capital costs of businesses or for home purchases, and the loans would not be made for ordinary consumer purchases.

So, the concept is that the financial institution would pay interest at a relatively low rate, but it would be tax exempt, making it attractive, and then that the financial institution would agree to turn around at roughly a 2.5-percent markup for its own costs and loan that back out for inventory financing and for business investment purposes.

Above all, Mr. Chairman, I think the Save America Savings Account concept will encourage people to save. I will remind the committee that individual savings in the United States are their lowest in 30 years, that they do lag significantly behind other major industrialized nations.

For example, the Japanese save 22 percent of their personal after tax income; the Germans, 14 percent; the French, 16 percent. In the fourth quarter of 1979, the savings rate in the United States hit an all-time low of 3.9 percent. As a result, productivity in this country is on the decline, and business in general does not have sufficient access to needed capital.

If our savings ratio continues to lag behind others, and our capital formation remains stunted, it is not a question of whether other nations will pass us by in productivity, but merely a question of how soon will it happen.

I would like to say that while I strongly believe in the basic concepts underlying this bill, Mr. Chairman, I fully recognize that the details that would be required to implement this concept remain to be worked out. To that end, I would welcome the suggestions of the chairman and other members of the committee or others to suggest how we could address the current problem and try to prevent any future recurrence of the grave economic difficulties that we have been passing through.

The long-range problem of increasing the savings ratio must be addressed. In addition, there must be safety nets to keep key areas of our economy from collapsing, if interest rates as high as those prevailing a few months ago should recur. Small businesses cannot finance inventories at interest rates like those prevailing just 2 or 3 months ago. Small farmers, home builders, and others were brought to the verge of bankruptcy, with a damaging effect on some financial institutions which could have set off a panic had they been driven over the brink.

Now, Mr. Chairman, I would say that concerns me very much. I realize the underlying problem with the interest rates was caused by the inflation and I realize that is caused by unbalanced budgets and excessive consumption of our resources by the public sector, but I am very concerned about what could have happened a couple of months ago had the high interest rates continued, and had small businesses started to fail, had the withdrawal rates in some of our financial institutions, savings and loans, for example, continued to the point that some of those became insolvent or in an unhealthy situation financially, if some of them had actually gone under, a panic could have ensued.

Mr. Chairman, we still do not have sufficient safety nets to protect us in the future if this kind of situation should recur. I certainly don't pretend to have all the answers.

Perhaps this proposal could be modified to allow for a sliding scale, depending upon prevailing interest rates. Seven percent is certainly not a magic figure. Perhaps it could trigger at only certain levels, if interest rates reached certain levels. As I have said previously, I invite the suggestions of the committee.

I realize also that this bill, even if it succeeded in attacking the two major problems about which I have spoken, would only be a small step in the right direction toward attacking our basic economic problems.

Not until we balance the Federal budget and begin to shift resources from the public to the private sector will we ever begin to get at the root causes of our declining productivity.

In the meantime, Mr. Chairman, members of the committee, I believe that something along the lines suggested in this bill could prevent grave economic problems, while we hopefully go to work on the basic changes that need to be made.

Senator **Byrd**. Thank you, Senator Boren.

Do you have an estimate as to the revenue loss?

Senator **Boren**. I do not have an exact estimate. I think the committee staff has been trying to work through one. It could be very significant. We could be talking in the range of $10 billion, depending upon how many people took advantage of this kind of action. Of course, really, the only thing we have to go on now are projections based upon our estimate on the small savers' exemption adopted by the committee earlier, where we acted on the $200.

So, it is pretty hard to know at this point how much it would be.

Senator **Byrd**. But you think it would run in the neighborhood of $10 billion?

Senator **Boren**. I think it could. I think one of the things that might be considered, and I don't know the full implications of this, is that by providing a pool of capital, if people really did respond to it, and if we did allow people to put up to $100,000 in these accounts, which would be $7,000 a year tax-free, could very well contribute a pool, a very stable pool of money as compared with some of the other sources that might be available through subsidized mortgage rates, bonds, and other proposals.

I think it would have to be viewed in conjunction with some of these, as to which means would be the most effective at the lowest cost of providing a pool of capital.

Senator **Byrd**. Thank you, Senator Boren.

[The prepared statement of Senator Boren follows:]

STATEMENT OF SENATOR DAVID L. BOREN

Mr. Chairman, let me say at the outset how much I appreciate the kindness and courtesy of the distinguished Chairman, my good friend, the Senator from Virginia, Senator Harry Byrd in setting aside time for a hearing on this important issue. I appreciate very much the thoroughness and diligence with which you have approached issues of taxation and economic policy in this Subcommittee. It is well known that few Subcommittees in the Congress work as hard as does this Subcommittee and its Chairman. So I thank you again for allowing me to appear before you today.

As the Chairman knows, he and I have shared a deep concern over the state of the economy in this country for many months. I first stated that concern in a speech on the Floor of the Senate in April. At that time, the prime interest rate had hit 20 percent, individual savings were at the lowest in 30 years and the rate of savings in the United States significantly trailed other major industrialized countries in the world.

Again, in the month of May, I pointed with alarm at the statistics which showed an ever-declining economy. On May 2nd, the Commerce Department had reported that the leading economic indicators had plunged 2.6 percent in March, the most in 5 years, and the third largest decline in the history of the Consumer Price Index. The Department also reported that new orders flowing to the Nation's factories fell by 1/10 of 1 percent in March, the largest drop in 8 months. Federal forecasters were expressing publicly doubts that the consumer price increases would slow by the summer and that this year's retail climb could top 14 percent, which would far outstrip the officially estimated 12.8 percent. The analysts around the country were saying privately that the basic inflation rate would hang somewhere between 10 and 12 percent.

Mr. Chairman, it is now the 24th of June and if one were to scan the headlines of the economic reporting services of this country, there might be some occasion for slightly rising optimism. For example, one national publication headlined an article yesterday, saying that the grip of recession could be easing, and those who want to see improvement, by searching somewhat diligently, seem to be able to find it in recent days.

Morgan Guaranty Trust has lowered the prime rate to 11½ percent and several savings and loan associations have dropped home loan rates to 12 percent. The word comes increasingly from sources from within the Administration that some sort of tax cut may be attempted this year.

But let us not be fooled, Mr. Chairman. Let us not believe that the road to recovery is, in fact, before us. Behind the optimistic headlines there is still the grim reality of an economy in serious trouble.

Last Friday, the Commerce Department reported that new factory orders for durable goods fell a seasonally adjusted 7.3 percent in May, the fourth consecutive monthly decline and the steepest since the 9 percent drop in December of 1974. Earlier in the week came a report that personal income increased only ⅒ of 1 percent in May, after declining by a like amount the previous month—housing starts continue to decline, the latest statistic shows a plunge of 11½ percent to the lowest level since July of 1975, which, Mr. Chairman, you will recall was the bottom of the last recession.

To top off the discouraging news of last week, the Commerce Department's preliminary estimate was that economic output is dropping at an unusually sharp 8.5 percent annual rate in the current quarter. Mr. Chairman, that is the second sharpest quarterly decline since the depression.

I mention these things, Mr. Chairman, as a counter-balance to the optimistic news that may well come today as the Administration releases their latest set of economic indicators.

We are not out of the woods. We still have serious problems, that demand serious action. I believe that S. 2646, the Save America Savings Account Act of 1980, is a framework within which we can construct a solid response to the economic problems I have outlined.

This bill will provide a needed safety net. It proposes the establishment of special tax-exempt "Save America" savings accounts to create a pool of money which could be loaned by financial institutions to farmers, small businessmen and prospective homeowners.

These accounts, to be offered through local banks and financial institutions, would pay seven percent interest. An individual could place no more than $100,000 in such accounts. These accounts would be attractive. In many cases a seven percent return, tax free, would give the saver more than a 14 percent return on which a tax is levied.

In return, banks which offer these "Save America" savings accounts would agree to loan the deposits in these accounts at not more than 9½ percent interest to be used for operating and capital costs of businesses for home purchases. The loans would not be made for ordinary consumer purchases.

Above all else, Mr. Chairman, the Save America Savings Account will encourage more people to save. I would remind the Committee that individual savings in the United States are not only the lowest in 30 years, but lag significantly behind most of the other major industrialized nations in the world. For example the Japanese save 22 percent of their personal aftertax income. Germans save 14 percent and the French save 16 percent. In the fourth quarter of 1979 the savings rate in the United States hit an all time low of 3.9 percent. As a result, productivity in this country is on the decline and business in general does not have sufficient access to needed capital.

If our savings ratio continues to lag behind others and capital formation remains stunted, it is not a question of whether other nations will pass us by in productivity, but merely a question of how soon it will happen.

I would like to say that while I strongly believe in the basic concept underlying this bill, I fully recognize that the details that will be required to implement this concept remain to be worked out. To that end, I would certainly welcome the suggestions of the Chairman or other members of the Committee, or outside agents who seek, as do we, to both address ourselves to the current problem and, equally important, try and prevent any future recurrence of these grave economic difficulties.

The long range problem of increasing the savings ratio must be addressed. In addition, there must be safety nets to keep key areas of our economy from collapsing if interest rates as high as those prevailing a few months ago should recur. Small businesses cannot finance inventories at interest rates like those prevailing just three months ago. Small farmers, homebuilders, and others were brought to the verge of bankruptcy with a damaging effect on some financial institutions which could have set off a panic had they been driven over the brink. We still do not have sufficient safety nets to protect us in the future and to provide reasonable interest rates for necessary business purposes as opposed to general increases in consumer pressures to spend which increase inflation.

I do not pretend to have all of the answers. Perhaps this proposal could be modified to allow for a sliding scale depending upon prevailing interest rates.

Perhaps it could trigger only at certain levels for interest rates. As I said previously, I invite the suggestions of the Committee.

I have no pride of authorship in this proposal. My strong motivation is a belief that the Congress owes it to the country to deal with this problem on an urgent basis.

I also realize, Mr. Chairman, that this bill, even if it succeeded in attacking the two major problems about which I have spoken, would only be a small step in the right direction toward attacking our basic economic problems. Not until we balance the federal budget and begin to shift resources from the public to the private sector will we ever begin to get at the root causes of our declining productivity.

In the meantime, I believe that something along the lines suggested in this bill will prevent grave economic problems while we hopefully go to work on the basic changes that need to be made.

Senator BYRD. Senator Nelson has a bill similar to this. We were going to hear Senator Glenn. Senator Glenn, how is your time situation?

Senator GLENN. Whatever the committee wants to do is fine with me.

Senator BYRD. All right. Senator Glenn, we will set this issue aside temporarily, and come back to it after hearing the Senator from Ohio.

Senator GLENN. My testimony will just take a few minutes.

Senator BYRD. We are glad to have you, Senator Glenn.

STATEMENT OF HON. JOHN GLENN, U.S. SENATOR FROM THE STATE OF OHIO

Senator GLENN. Thank you very much.

Mr. Chairman, I appreciate very much this opportunity to appear before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee to testify in favor of S. 2493, which I introduced on March 28, 1980.

S. 2493 is a bill to amend the Internal Revenue Code so as to allow for the deferral of the payment of the Federal excise tax on tires, tubes, and tread rubber. At present, manufacturers must pay an excise tax of 10 cents a pound for the tires and tubes and 5 cents a pound for tread rubber which they produce.

This tax must be paid to the Treasury twice monthly. These twice monthly payments must be made even though the manufacturers generally do not receive payment from their customers for up to 90 days after the sale to them.

The disparity between the payment of the tax and the receipt of revenue has exacerbated an already serious cash flow problem which the tire manufacturers are experiencing. The excise tax payments which the tire manufacturers must make are considerable.

In 1979, the tire industry paid $878 million to the U.S. Treasury due to the tire excise tax. With an average financing period of 90 days, and with the prime rate at 12 percent, the cost of financing the excise tax payments is running at an annual pace in excess of $25 million.

If the excise tax payments could more closely coincide with the customer payments to the manufacturers, the excise tax financing expenses could be substantially reduced or eliminated.

S. 2493 seeks to achieve that result by changing the time for payment of the excise tax from the present twice monthly to 90 days after the end of the month in which the product is sold by the manufacturer.

Mr. Chairman, I would emphasize, this will not change in any way the amount of tax paid. It will only change the timing of the payment. It is my hope that this legislation can help to reduce the financing expenditures for an industry which is undergoing very severe financial difficulties, layoffs, plant closings due to the downturn in domestic automobile sales.

I respectfully request that the Finance Committee consider and favorably report out this important legislation at the earliest possible time.

Mr. Chairman, I appreciate your consideration in letting me give my testimony at the present time.

The president of the Rubber Manufacturers Association will be testifying later on this afternoon, Mr. Mac Lovell. I regret I will not be able to remain and introduce him to the committee, but he will be giving his testimony later on this afternoon.

I would only emphasize once again that what I am proposing with this bill would in no way change the amount of the tax paid to the Federal Government, only the timing of the payments to coincide with the time period that the manufacturers normally are paid by their customers.

I thank the committee for its consideration.

Senator BYRD. Thank you, Senator Glenn.

The prepared statement of Senator John Glenn follows:]

STATEMENT BY SENATOR GLENN BEFORE THE SENATE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT CONCERNING S. 2493.

Mr. Chairman, I appreciate this opportunity to appear before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee to testify in favor of S. 2493, which I introduced on March 28, 1980.

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The excise tax payments which the tire manufacturers must make are considerable. In 1979 the tire industry paid $878 million to the U.S. Treasury due to the tire excise tax. With an average financing period of 90 days and with the prime rate at twelve percent the cost of financing the excise tax payments is running at an annual pace in excess of $25 million.

If the excise tax payments could more closely coincide with the customer payments to the manufacturers, the excise tax financing expenses could be substantially reduced or eliminated. S. 2493 seeks to achieve that result by changing the time for payment of the excise tax from the present twice monthly, to 90 days after the end of the month in which the product is sold by the manufacturer. This will not change the amount of tax paid, but only the timing of the payment.

It is my hope that this legislation can help to reduce financing expenditures for an industry which is undergoing severe financial difficulties, layoffs, and plant closing, due to the downturn in domestic automobile sales.

I respectfully request that the Finance Committee consider and favorably report out this important legislation at the earliest possible time.

Thank you.

Senator BYRD. At this time, we will depart slightly from the regular order, and I will ask Mr. Max Karl, chairman of the board of MGIC Investment Corp. of Milwaukee, Wis., if he would come to the table, and Mr. W. C. Smith, president, Franklin Town Reality, Inc., Pittsburgh, Pa.

Senator Nelson has legislation which I understand is similar to enator Boren's, and it would be good, I think, if these two meas- res could be considered together. The record will reflect this revi- on.

Senator Nelson?

STATEMENT OF HON. GAYLORD NELSON, U.S. SENATOR FROM THE STATE OF WISCONSIN

Senator **Nelson**. Mr. Chairman, last April I introduced S. 2560. his measure would provide an exclusion from gross income for nterest and dividends earned on savings deposits which are used y the deposit institution for residential mortgage lending pur- oses. I will ask, in order to economize on time, Mr. Chairman, and ecognizing that you have a number of witnesses here, I will simply sk that my statement which covers the situation on housing in he State of Wisconsin, the number of housing starts in particular, nd some explanation of the proposal, simply be printed in full in he record as though read in order to save time.

Senator **Byrd**. Without objection, it is so ordered.

Senator **Nelson**. We have two witnesses today who are experts nd who are well acquainted with the housing business. Mr. Max Karl is primarily engaged in the business of providing mortgage nsurance for residential housing loans. Mr. Smith is a Pittsburgh uilder, developer, and realtor, who has long been active in making nore housing available at lower cost for our Nation's young home ouyers. So, Mr. Chairman, I would ask that this be printed in the ecord and that we move to Mr. Karl's statement.

Senator **Byrd**. Very well. Mr. Karl?

[The prepared statement of Senator Nelson follows:]

STATEMENT OF SENATOR GAYLOR NELSON

Mr. Chairman, this afternoon the Subcommittee on Taxation & Debt Management vill receive testimony on a number of miscellaneous tax bills. Among the subjects to e considered today is legislation designed to help the ailing housing and construc- ion industries.

This past April I introduced the Home Mortgage Assistance Act of 1980, S. 2560. This measure would provide an exclusion from gross income for interest and divi- lends earned on savings deposits which are used by the deposit institution for esidential mortgage lending purposes.

Mr. Chairman, inflation is dealing a crippling blow to our Nation's economy. Nowhere is this clearer than in the housing industry which is dominated by small ousinesses. It is a victim of a vicious inflationary spiral and extraordinary and oppressive interest rates.

Builders and subcontractors are on the verge of bankruptcy. In my state of Wisconsin housing starts are down 90 to 95 percent across the state. The National Association of Home Builders estimates Wisconsin faces the loss of 42,000 construction jobs in 1980. Widespread unemployment will kill our chances to balance the oudget. A one percentage point increase in the unemployment rate increases the federal deficit by some $25 billion as tax revenues decline and unemployment payments increase. Millions of young American families have been priced out of the housing market, many of them permanently.

Today's real estate markets, which should be running at peak capacity to supply an ever-growing need, are instead being crushed under the weight of inflation. Construction declines, high mortgage interest rates, faltering consumer incomes and the decline of new home sales are all serious problems which must be solved immediately.

The basic problem is how to provide an adequate supply of money sufficient to meet the needs for investment in housing at a price which will enable the customers to purchase the housing they need.

The Home Mortgage Assistance Act, by giving a total tax free treatment to interest earned by depositors on deposits used for residential mortgage purposes (the same tax free treatment given municipal bond interest), solves the problem.

This proposal, by giving an "after tax" advantage to the depositor, where the deposits are used for residential mortgage purposes, establishes a constant spread or differential in favor of such deposits. It will allow savings institutions to pay a reasonable interest rate on their deposits which would be equivalent to a much higher taxable interest rate. This, in turn, will allow the institutions to originate mortgage loans at a much lower and more reasonable rate.

Under this bill, a tax exemption would apply to all deposits used for residential mortgage purposes. A residential mortgage deposit account would be established in any savings institution and funds would be segregated internally for residential mortgage purposes. The only requirement is record keeping and identification for tax purposes.

A strong inflow of savings would bring our economy back to the two million housing start level which has often been defined as a minimum need for this country. A substantial increase in housing activity will put more construction trades people to work, produce more housing related jobs, etc. It will also contribute significantly to our attempts in balancing the federal budget.

Mr. Chairman, we are pleased to have with us today two witnesses who are well acquainted with the problems confronting the housing and construction industries.

Mr. Max Karl is chairman of the Board and chief executive officer of MGIC Investment Corporation. Mr. Karl's company is primarily engaged in the business of providing mortgage insurance for residential housing loans. He has first hand knowledge of the many economic difficulties of the home building industry and he is in a unique position to understand the concerns of the Nation's potential home buyers.

Mr. W.C. Smith is a Pittsburgh builder, developer and realtor who has long been active in making more housing available at a lower cost to our Nation's young homebuyers.

I look forward to reviewing the testimony of these distinguished gentlemen.

STATEMENT OF MAX KARL, CHAIRMAN OF THE BOARD, MGIC INVESTMENT CORP., MILWAUKEE, WIS.

Mr. KARL. Mr. Chairman, members of the committee, I ask leave to file my full statement, and I offer in testimony a shorter version of it.

Senator BYRD. It will be received. You may proceed.

Mr. KARL. Twenty-three years ago I founded Mortgage Guaranty Insurance Corp., which is the principal subsidiary of MGIC Investment Corp., and is the nation's first and largest private mortgage insurer of this modern era. It is really the private counterpart of the FHA.

That organization and the industry which it spawned have placed over 4 million deserving families into homes of their own. Typically, these families had relatively modest incomes at or below 125 percent of the median income, and they were really in need of help because of their small down payments. Our industry to date has insured over $150 billion of home loans.

Senator NELSON. $150 billion?

Mr. KARL. $150 billion. And in so doing, competes very successfully with the FHA on a private basis.

As a result of this experience, I have been a long-time student of thrift and home ownership in the United States and throughout the world. What I see today distresses me greatly. The Nation and the world face a debilitating capital shortage. A decade of rapid growth. In many nations, an accelerating inflation has reduced savings flows grievously. Nowhere is this more evident than in the United States.

After averaging over 6 percent of disposable income during most of the post World War II period, personal savings have declined dramatically in the last 5 years, down from 7.5 percent to 3.5 percent. The U.S. record compares poorly with that of other western nations, many of which have provided tax incentives for savings.

The latest data show a 9 percent savings rate in Canada, a 17-percent savings rate in France, 14 percent in Germany, 25 percent in Japan, and——

Senator NELSON. These are percentages of disposable income?

Mr. KARL. Of disposable income. And 17 percent in the United Kingdom. And that compares to our 3.5 percent.

The decline in the personal savings rate holds dire consequences for virtually every aspect and segment of our economy, but no sectors are hit harder than housing, and the financial intermediaries that provide residential mortgage finance.

An increase in the level of savings and investments are critical to controlling the inflationary forces which grip this Nation, pollute the national currency, and endanger our competitiveness in world markets.

Senate bill 2560, introduced by Senator Gaylord Nelson, recognizes this fact, and provides incentives for thrift which in my judgment will work to permanently increase the rate of personal savings. S. 2560, the Home Mortgage Assistance Act, would channel these new savings funds toward the housing industry. This is important both in the short run and in the long run. Housing today is in desperate straits.

Housing starts have fallen below the 1 million level. Actually, they are at 920,000 units. It is the second lowest level recorded since this data series began in 1945. Unemployment in residential construction and related trades is rising, and today exceeds 17 percent, or 1.4 million workers, according to the National Association of Homebuilders.

Even with mortgage interest rates falling back to the 12-percent level, we find relatively few buyers. Potential homeowners are understandably reluctant to take on the big monthly payments associated with these high interest rates. Unprecedented numbers of loan applicants find they cannot qualify for a mortgage loan at current interest rates.

The twin problem of mortgage money availability and affordability are long term in nature and need to be addressed with long-term solutions. We need to face these problems now before they are further aggravated by demographic forces.

The largest number of first-time home buyers today are between the ages of 25 and 34. Americans in that age bracket will grow from 36 million this year to over 41 million in 1990. The effect of higher interest rates on monthly mortgage payments and the annual income requirements for home ownership is dramatic. Purchase of the average home, the average home, $69,400, which is what——

Senator NELSON. Is that the nationwide average?

Mr. KARL. That $69,400 is as of last March. That was determined to be the average cost of housing.

Senator NELSON. Nationwide?

Mr. KARL. Nationwide. At a 12-percent interest rate, that would require an income of $30,864 to carry a $643 monthly payment.

Now, at 8 percent, the monthly payment would be only $458, or $185 less per month. That would require, for qualification purposes, a $21,984 income. That is for the same house.

Senator NELSON. You mean, the income required at 12 percent would be $30,000?

Mr. KARL. To qualify, yes. In order to qualify, you would have to have $30,864 at 12 percent, but only $21,984 at 8 percent, and by the way, the average income is $21,350. The Conference Board came out with those statistics. So, the $21,900 which qualifies for an 8 percent loan is just about the average household income.

Now, the higher rate, the 12-percent rate, excludes 15 million households from purchasing a house today. Prominent housing economists agree that the nation needs 2.2 million new housing units per year throughout the decade of the 1980's to meet housing demand.

To the extent that the housing finance infrastructure is unable to support that level of construction, scarcity will prevail in both ownership and rental units. Any shortfall of supply can cause inordinate housing price increases, as was the case in the late 1970's. Since S. 2560 would raise new funds and stabilize housing output, it clearly has the potential to keep demand and supply in better balance and hold down price rises.

Some critics may view this plan as inflationary. In reality, the opposite is true. While it is granted that new housing can have some inflationary impact in the year of construction, it should be noted that it has a dampening effect for many years afterward. Building equity in a home is anti-inflationary, as it diverts funds from the spending stream.

The extremely low level of personal savings today is both a cause and a result of inflation. To the extent that the plan proposed here is successful in increasing the rate of personal savings, it will draw funds away from personal consumption, and have a decidedly inflationary impact. The principal benefits offered to the economy by the proposed plan are an increased level of savings and added stability in the housing sector.

During recent recessions, housing has been highly volatile. The valleys have been 50 percent below the peaks, and the related unemployment has been massive. It was 25 percent in 1975. Even a slight moderation of the cycles can bring enormous revenues to the Treasury.

The National Association of Home Builders estimates that 1.4 million jobs will be lost this year in residential construction and related trades, when compared to the normal employment of 1978. Such housing unemployment adds 1.3 percentage points to the national total.

A recent study published by the Congressional Budget Office concludes that a 1 percentage point increase in unemployment will create a Treasury revenue loss of $20 billion to $22 billion plus increased unemployment costs of $5 billion to $7 billion. A one point three point increase translates into a deficit increase of more than $35 billion.

Faced with problems so deep and far-reaching as the availability and affordability of mortgage funds in the 1980's, some may seek a quick fix. More fundamental approaches are advised.

Senator Nelson's proposal links savings incentives to the chalenge of providing affordable mortgage funds to home buyers. Adoption of S. 2560 could have a significant stabilizing effect on ousing cycles, employment, and prices, and it would accomplish ts end in the private sector, substantially reducing the need for overnment subsidies in housing, and reversing the trend toward ocialization and housing finance.

Summing up, Mr. Chairman, the need for fresh approaches to timulate more savings in this nation is an imperative in the 980's. It is also critical that a fair share of such funds be chaneled into housing. Without this effort, the dream of a home of ne's own will be simply that, only a dream.

The adoption of the principles in S. 2560 could help turn that ream into a reality for growing numbers of families without new overnment programs or subsidies.

Senator Nelson is to be highly commended for his sponsorship of he bill. I urge full support for his program.

Senator Byrd. Thank you, Mr. Karl.

Would you give an example, now, as to how S. 2560 would work?

Mr. Karl. All right. I would assume that a tax free account at a avings and loan association, for example, a thrift institution, could e established at a 6 percent interest rate, tax free.

Senator Byrd. An individual would——

Mr. Karl. Would bring his—let's say he were to bring——

Senator Byrd [continuing]. Bring $100,000, or whatever the igure might be.

Mr. Karl. Let's say he would bring $10,000 into the association and open up a tax free savings account. He would probably get about 6 percent for that if it were tax free. That would be the equivalent of something close to 9 percent as a pretax yield.

That money would then be channeled into housing, into mortgages, at this association. Now, it may be very difficult to have all of this money go immediately into the mortgages that would be segregated for this purpose. There may be a lead time that would be necessary. There may be 6 months it may be necessary for the association to put all its money into these mortgages.

It is conceivable also that the savings and loan association could not put all of this money into housing. I would suggest if that were not possible, that the institution pay the tax that would normally be paid by the saver, were it not for this tax exemption.

So, it would not be possible then to take tax free dollars and put it into investments other than single family housing.

Senator Byrd. It would only be tax free to the individual investor. It wouldn't be tax free to whatever earnings the savings and loan might make on it.

Mr. Karl. No; that is true, but it would have the impact of bringing down this huge interest rate on mortgages. This 12 percent rate, in my opinion, would be brought down to 8 percent.

Senator Byrd. Senator Boren's proposal puts a ceiling of $100,000. Is that about in line with your thinking?

Mr. Karl. That doesn't disturb me, although I do think that the demand for housing money is going to be so great that we will have to rely on not just small savings, but the more affluent saver as well, in order to meet the need for housing.

Senator **Byrd**. You feel if legislation like this is enacted, that it should have a ceiling, but it should have a relatively high ceiling?

Mr. **Karl**. Yes; I would think so.

Senator **Byrd**. You feel $100,000 is about the right figure, do you?

Mr. **Karl**. I think $100,000 would bring in much more money than is going into thrift institutions today, but certainly if you had no limit, it is conceivable that some institutions, pension funds, for example, might very well want to invest some of their moneys in this manner, and this would bring in the additional funds that I think we are going to need in the eighties in order to meet the tremendous housing needs.

Senator **Byrd**. Do I sense a reluctance on your part to advocate a ceiling?

Mr. **Karl**. No; I don't have a reluctance toward it. I think anything we can do to improve the present situation would be more desirable, of course. We can improve it much more by having no ceiling. We can improve it greatly, nonetheless, by having a $100,000 limit.

Senator **Nelson**. May I ask a question here? If part of the objective, and you briefly addressed that point, is to induce individual savings, would it not be so that some ceiling would be helpful with that, because it wouldn't induce additional savings if pension funds were being invested, because that is already pulled out of——

Mr. **Karl**. I think if we are looking purely at this bill as a tax incentive for savings, as a bill that might stimulate savings, then, certainly the $100,000 limit would be appropriate. If we are thinking in terms of getting enough money into the system for the purpose of meeting much more in the way of housing, then I think we ought to go to all sources of funds and try to induce those funds to put money into these kinds of institutions.

Senator **Byrd**. Thank you.

[The prepared statement of Mr. Karl follows:]

STATEMENT OF MAX H. KARL, CHAIRMAN
MGIC INVESTMENT CORPORATION
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
UNITED STATES SENATE
S.2560,THE HOME MORTGAGE ASSISTANCE ACT

Mr. Chairman, Members of the Committee - my name is Max H. Karl. I am a native of Milwaukee, Wisconsin, and am Chairman of MGIC Investment Corporation of that city. Twenty-three years ago I founded Mortgage Guaranty Insurance Corporation, the principal subsidiary of MGIC Investment Corporation and the nation's first and largest private mortgage insurer of the modern era. That organization and the industry which it spawned have placed over four million deserving families into homes of their own. Typically these families had relatively modest incomes, at or below 125% of median income, and were in need of help with a downpayment. Our industry to date has insured over $150 billion of home loans and in so doing competes successfully with the Federal Government in the form of the Federal Housing Administration.

As a result of this experience, I have been a long-time student of thrift and home ownership in the United States and throughout the world. What I see today distresses me greatly. The nation and the world face a debilitating capital shortage. A decade of rapid growth in many nations and accelerating inflation has reduced saving flows greviously. Nowhere is this more evident than in the United States. After averaging over 6% of disposable income during most of the post World

War II period, personal saving has declined dramatically in recent years:

	Personal Savings Rate
4th Quarter 1974	7.5%
4th Quarter 1975	6.7%
4th Quarter 1976	5.2%
4th Quarter 1977	5.1%
4th Quarter 1978	4.7%
4th Quarter 1979	3.5%

The U.S. record compares poorly with that of other western nations, many of which have provided tax incentives for savings. The latest data show a 9% savings rate in Canada, 17% in France, 14% in Germany, 25% in Japan, and 17% in the United Kingdom.

The decline in the personal saving rate holds dire consequences for virtually every aspect and segment of our economy, but no sectors are hit harder than housing and the financial intermediaries that provide residential mortgage finance.

An increase in the levels of savings and investment are critical to controlling the inflationary forces which grip this nation, pollute the national currency and wealth, and endanger our competitiveness in world markets. S.2560, the bill introduced by Senator Gaylord Nelson, recognizes this fact and provides incentives for thrift which, in my judgment, will work to permanently increase savings rates.

S.2560, The Home Mortgage Assistance Act, would channel these new savings funds towards the housing industry. This is important both in the short run and the long run. Housing today is in desperate straits. Housing starts have fallen below the

1,000,000 unit annual rate and stand at the lowest level recorded since the data series began in 1945. Unemployment in residential construction and related trades is rising and today exceeds 17% according to the National Association of Home Builders. Even with mortgage interest rates falling back to the 12% level, we find few buyers. Potential homeowners are understandably reluctant to take on the big monthly payments associated with these interest rates. Unprecedented numbers of loan applicants are finding they cannot qualify for a mortgage loan at current interest rates.

The twin problems of mortgage money availability and affordability are long term in nature and need to be addressed with long-term solutions. We need to face these problems now before they are further aggravated by demographic forces. The largest number of first time home buyers today are between the ages of 25 to 34. Americans in that age bracket will grow from 36 million this year to over 41 million in 1990.

The effect of higher interest rates on monthly mortgage payments and the annual income requirements for home ownership is dramatic. Purchase of the average home, $69,400 as of March 1980, at a 12% interest rate would require an income of $30,864 to carry the $643 monthly payment; at 8% the monthly payment of $458 would take an annual income of only $21,984 for the same house. Median household income in the U.S. is presently $21,350 according to the Conference Board. The higher interest rate excludes 15 million households from home ownership.

EFFECT OF VARIOUS INTEREST RATES ON MONTHLY PAYMENT AND ANNUAL INCOME REQUIREMENTS FOR HOME MORTGAGE LOANS

House Price	8% Interest Monthly Payment	8% Interest Needed Annual Salary	10% Interest Monthly Payment	10% Interest Needed Annual Salary	12% Interest Monthly Payment	12% Interest Needed Annual Salary	14% Interest Monthly Payment	14% Interest Neede Annua Salar
$45,000	$297	$14,256	$356	$17,088	$417	$20,016	$480	$23,04
55,000	363	17,424	435	20,880	509	24,432	587	28,1
65,000	429	20,592	514	24,672	602	28,896	693	33,2
75,000	495	23,760	593	28,464	695	33,360	800	38,4
85,000	562	26,976	672	32,256	787	37,776	907	43,5
Avg. Existing House: $69,400 (March 1980)	$458	$21,984	$548	$26,304	$643	$30,864	$740	$35,52
Avg. New House: $72,400 (March 1980)	478	22,944	572	27,456	670	32,160	772	37,05

Assumptions: 10% Downpayment
25% Gross Monthly Income to Housing (P&I Only)
30 Year Mortgage Term

Existing Price Per NAR; New Price Per NAHB

Prominent housing economists agree that the nation needs 2.2 million new housing units per year throughout the decade of the 1980's to meet housing demand. To the extent that the housing finance infra-structure is unable to support that level of construction, scarcity will prevail in both ownership and rental units. Any shortfall of supply can cause inordinate housing price increases, as was the case in the late 1970's. Since S.2560 would raise new funds and stabilize housing output, it clearly has the potential to keep demand and supply in better balance and hold down prices rises.

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Some critics may view this plan as inflationary. In reality the opposite is true. While it is granted that new housing can have some inflationary impact in the year of construction, it should be noted that it has a dampening effect after completion. Building equity in a home is anti-inflationary, as it diverts funds from the spending stream. Housing-related expenses normally can draw off 35% of household income, thus reducing the finds otherwise available to fuel inflationary fires via consumer spending.

The extremely low level of personal savings today is both a cause and a result of inflation. To the extent that the plan proposed here is successful in increasing the rate of personal savings, it will draw funds away from personal consumption and have a decidedly deflationary impact. A plan to channel affordable funds into housing should not be considered inflationary when compared with the alternative of scarce housing and scarce mortgage funds.

The principal benefits offered to the economy by the proposed plan are an increased level of savings and added stability in the housing sector. During recent recessions, housing has been highly volatile. The valleys have been 50% below the peaks, and the related unemployment has been massive (25% in 1975). Even a slight moderation of the cycles can bring enormous revenues to the Treasury. The National Association of Home Builders estimates that 1.4 million jobs will be lost this year in residential construction and related trades, when compared to the normal employment of 1978. Such housing unemployment translates into 1.3 percentage point increase in the national total. A study published by the Congressional Budget Office in February, 1980 concludes that a one percentage point increase in unemployment will create a Treasury revenue loss of $20-$22 billion, plus increased unemployment costs of $5-$7 billion. A 1.3 point increase translates into a deficit increase of more than $35 billion.

Faced with problems so deep and far-reaching as the availability and affordability of mortgage funds in the 1980's, some may seek a "quick-fix". More fundamental approaches are advised. Senator Nelson's proposal links savings incentives to the challenge of providing affordable mortgage funds to home buyers. Adoption of S.2560 could have a significant stabilizing effect on housing cycles employment and prices. And it would accomplish its ends in the private sector, substantially reducing the need for government subsidies in housing, and reversing the trend toward socialization in housing finance.

Summing up, Mr. Chairman, the need for fresh approaches to stimulate more savings in this nation is an imperative in the 1980's It is also critical that a fair share of such funds be channeled into housing. Without this effort the dream of a home of one's own will be simply that - a dream for growing numbers of Americans. The adoption of the principles in S.2560 could help turn that dream into a reality for growing numbers of families and do it without new government programs or agencies. Senator Nelson is to be commended for his sponsorship of the Bill. I urge support for his program.

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Senator BYRD. Mr. Smith?

STATEMENT OF W. C. SMITH, PRESIDENT, FRANKLIN TOWNE REALTY, INC., PITTSBURGH, PA.

Mr. SMITH. Thank you.

Mr. Chairman, members of the committee, my name is W. C. Smith, and I am a homebuilder, developer, and realtor from Pittsburgh, Pa. I appreciate the opportunity to appear here today and testify on Senator Nelson's bill, and I have a more detailed statement for the record.

Senator BYRD. It will be received.

Mr. SMITH. Tax-free treatment of savings deposits used for residential mortgage purposes under this bill would achieve the following effects. In my judgment, a mortgage rate today of 5.5 to 6 percent would permanently eliminate this intermediation, reduce inflation in housing, stimulate the production of rental housing from the private sector without direct government subsidy, while reducing Federal expenditures in providing rental housing, reverse the Federalization of housing, and make single family and rental housing affordable for all Americans.

It would restore economic growth to the savings and loan industry by reducing their average cost of money far below their average portfolio value, and reestablish the value of their existing older rate mortgages. It would restore employment and create new employment in housing and related industry. It would eliminate the cycles in the housing industry.

Now, I would like to explain how I came to the conclusion of a 5.5- to 6-percent mortgage rate. Housing authority construction notes are the closest comparable to this type of investment.

Senator NELSON. What kind of construction?

Mr. SMITH. Housing authority construction notes, HUD notes. Last week, we were averaging on a bid price of 3.8 to 3.9, under 4 percent. Now, they are a close comparable because they are municipals, and they are insured by the Federal Government.

Now, yesterday, the Wall Street Journal reported that short-term municipals were averaging [illegible] percent, and if you look at the recent municipal issues for housing back bonds, you will see that some of them were as low as 4.75 percent, but they are around 5 percent.

There is a 1-percent disadvantage when you go through a bond issue involving bond council and things like that. You would get the market rate for housing authority construction notes or something comparable to that, that would produce a cost of money in the form of deposits of approximately 4 percent. With an average markup of 1.5 to 2 percent, this would produce a residential mortgage rate today of 5.5 to 6 percent, because you have a convenient deposit, tax free, insured by the Federal Government.

Now, there would be no better or more preferred or more safe investment in the United States. So therefore we wouldn't experience the things that we have experienced before, the flow of funds out of savings institutions and out of the traditional sources of housing funds.

This would permanently solve that problem and establish a permanent equilibrium between the source of supply of money for housing and source of supply of money for other investments, so that in the future what would occur is that the rate of mortgages in the best scenario-worst scenario situation would fluctuate between 4.5 and 9.5.

Now, we get to the area of housing affordability, which is the key thing in the eighties. We may agree or disagree as to how many houses we need, but the key to housing affordability is the monthly payment. The key to the monthly payment is the mortgage rate. The key to the mortgage rate is the cost of money in the form of deposits.

Now, I have heard the chairman of the Federal Home Loan Bank Board say that the average rate of mortgages would not get below 10.5 percent. We asked him at one meeting how you get affordability, and he said, tax incentives targeted to housing.

Now, I would submit in this instance we would be able to produce today a 6 percent residential mortgage rate. That rate would reduce the cost of a $50,000 mortgage on a monthly basis by $200 a month. Now, obviously, this is going to be deflationary, because you are going to reduce the cost of living for individuals. You are going to reduce the cost of housing in the CPI. In addition to that, since you reduce the cost of housing, you are not going to have the pressure for increased wages.

Now, this is going to make, then, single family housing affordable for everyone. We get into the rental housing market, and the reason people are not producing rental housing today is, you can't make a profit, and the reason you can't make a profit is, the interest rates are so high, you can't get a return on investment.

If this bill were passed, you would produce a residential mortgage rate of around 6 percent. This is a rate which is 1.5 percent lower than the present Federal direct subsidy rate for rental housing at 7.5 percent. That would mean that the private sector today then would be able to produce almost all the residential rental housing that is required in the United States without any direct Federal subsidies.

Now, I think that the reason the Federal Government has become more and more involved in housing is because they have precluded the private sector from functioning. The key to this whole area is the cost of deposits.

I would like to comment on one of the areas of inquiry of Senator Byrd about the limits. To achieve the optimum here, you have to let the free market function to get the rate down. Now, the amount of money required for housing through the eighties to create the number of units is going to be the same. That is, one roof costs the same amount of money whether it comes from the private sector or the public sector. So, we are going to have to produce that, politically and economically, whether the number is 2.2 million or 2.8 million or 3 million. We have to produce the same number of roofs.

Now, if you let a private sector system function by letting the existing institutions such as the banks and savings and loans provide this source of funding, I would submit to you that it is a lot less expensive than imposing taxes, collecting those taxes, establishing Federal agencies, and redistributing the funds to create the same number of housing units. In this instance, you would be able to reduce the cost of living by letting the private sector function and start to totally reduce if not eliminate most of the Federal housing programs.

Now, I know you are interested in the problem of revenue loss. I have talked to the people in the Joint Tax Committee. They say, first, if you exempted all savings in institutions of this type from taxation, the estimated revenue loss is $17 billion. If you limit it to those institutions involving housing, it gets down to $13.5 billion.

Now, we have already passed—not we, but the Congress of the United States has passed the Bentsen bill. That bill has a value relative to housing maybe somewhere in the area of $2 billion, the housing institution. So now we are getting down in the range of $11 billion. Mortgage revenue bonds have a revenue loss value, and that is displacing funds which come from the S. & L. So now you are down to $10 billion.

Now, $10 billion might be a good number, and you don't have any supply side effect, and you don't have any indication of reduction of expenditures because the private sector will be solving its problem.

Let's look at that February report of the Congressional Budget Office. The CBO report says that 1 percent or 1 million employment represents $22 billion lost revenue and $7 billion expenditure. Now, we are already above that number in the housing industry today. If we were just to restore employment in the housing industry, this has an asset value in the budget of approximately $29 billion.

We have been waiting, thinking of the Joint Economic Committee getting the supply side model for different things, but here, we have something that works from the CBO. The reciprocal of $22 billion unemployment certainly would seem to function if you put more people in employment and more people working and more businesses contributing to the national revenues.

So, if you were to meet an objective of 1 million more houses, that should produce revenue of $22 billion and reduce the chronic unemployment of other people who are marginally unemployable by that $7 billion.

So, it would seem that you have two aspects here. If the direct revenue cost is $10 billion, if you put people back to work in the housing industry, that has an asset value of approximately $30 billion, or a 3 to 1 return.

Now, if you go out and build the houses that we need during the eighties on an annual basis, and that represents another 1 million units per year, it should generate $22 billion in revenue and should generate a reduction of unemployment expenditures of $7 billion or $30 billion.

That gives you actually a 6 to 1 return.

I would submit to you that most of the Federal direct expenditures, the section 8 programs, the direct subsidy programs for interest, and some of the other subsidy programs, a very large percentage of those would be reduced or eliminated because the private sector would be solving the problem, and these are additional reductions of Federal expenditures.

I think that generally summarizes my feeling about this bill. I think that if we go back to basics, Senators, that we are going to be able to let the private sector provide all the housing that is needed through the eighties and get the Federal Government predominantly out of the housing industry. We are going to reduce the cost of doing this to the Government, and reduce the cost to the consumer of housing.

Senator BYRD. I would like to see the private sector do the job rather than the Government.

You say you feel that the interest rate can be brought down to 6 percent. That is about half what the rate is now, isn't it?

Mr. SMITH. That is exactly right, sir.

Senator BYRD. Over what period of time do you estimate that it could be brought down to 6 percent?

Mr. SMITH. This is almost an instantaneous effect, because we have seen how rapidly the rate has risen when we had money market funds in the bidding for money. We have also seen recently how rapidly the rate has come down.

So, what you would have occur, you may have a movement of funds. You would have a situation in which you could let the banks and S. & L.'s expand their investment in commercial type investments at a different rate. You have a switching of funds into those tax-free accounts within the savings institutions, and I would say you are looking at a 60-day period of time, in my judgment.

Now, there is another interesting aspect of this that I didn't comment on in my written testimony. There is a great concern about the shifting of funds out of communities and into money market funds in the New York area. One of the things that this would do is reduce that shifting of funds, and the reason it occurs is because local people who generate profits and generate savings are looking for the best after tax rate of return. They can't get it at home, and as a consequence, they ship their money out.

Now, this would provide a local opportunity for investment in local institutions on a tax-free basis. Those funds would then remain within those communities and provide adequate funds for all the housing needs of that community. Now, the effect on other forms of businesses within that community results from the fact that that community now is going to have a greater aggregate of funds. Those funds which come in at a lower marginal tax rate, at a higher interest rate, would then remain to provide the funding for other activities within the community.

Overall, the community would retain a greater percentage of its funds, and there would not be the flight of funds from local communities into the New York money market funds, and in many instances into overseas investment through those funds.

Senator BYRD. So, assume that no legislation of this type is enacted. What would you estimate the housing starts for calendar year 1980 to be?

Mr. SMITH. For the calendar year 1980, I discussed this with—I think I have talked to most of the chief economists throughout the country, and I gave Otto Eckstein my estimate in October of under 900,000 units, and I would say that we are looking at under 900,000 units right now, and my personal estimate of the need is somewhere around 2.7 million, 2.8 million.

That means we are accumulating demand, and once this market frees up, which inevitably it will, I project inflation in housing next spring at 22 percent.

Senator **Byrd**. Inflation in housing at 22 percent?

Mr. **Smith**. Yes, sir.

Senator **Byrd**. If the housing starts keep up as they are now?

Mr. **Smith**. Yes, because what we are doing, first, if you accept some of the numbers, some people would say we have 1.7 million, 1.8 million family formations a year—that is from the Joint Economic Committee—600,000 demolitions, 600,000 differential migration. You get up to about 3 million units a year. Some people would say 2.7 million. Now, in 1979, we produced 1.8 million annualized. This year we will be down around 8,000 to 9,000.

Now, that means we have accumulated demand during this period of time of at least 2 million units. Now, this year, if we accumulate demand at 2 million units and 1 million from 1979 that couldn't possibly buy housing, that is 3 million units. The basic demand for housing is approximately 2.7 million to 3 million units. We go into 1981 with accumulated demand of 3 million and annual demand of 3, that is 6 million.

Now, with plywood plants and portland cement plants and dimensional lumber plants and glass plants having limited capacity, once housing cranks up again, you are inevitably going to have inflation in housing next spring, in my judgment anywhere from 22 to 25 percent.

That is a simple expression of the law of supply and demand. The only way you can reduce the cost of housing is by producing housing. When you reduce the production of housing or the population, the demographics increase, you inherently create inflation, and until the Federal Reserve Board and the Federal Government starts to recognize this, we are building in inflation and accumulated demand on an annual basis is going to run around 22 percent. Short term, I would say 18 percent, 15 percent from here on in.

Senator **Byrd**. Thank you, Mr. Smith.

Senator Nelson?

Senator **Nelson**. No questions, Mr. Chairman.

Senator **Byrd**. Thank you, Mr. Smith.

Mr. **Smith**. Thank you, gentlemen.

[The prepared statement of Mr. Smith follows:]

STATEMENT OF W. C. SMITH ON S.2560, BEFORE THE SENATE FINANCE COMMITTEE, SUB-COMMITTEE ON TAXATION

Mr. Chairman and Members of the Subcommittee:

My name is W. C. Smith, and I am a home builder, developer, and Realtor from Pittsburgh, Pennsylvania. I appreciate the opportunity to appear today and express my opinions in support of S.2560.

Tax free treatment of savings deposits used for residential mortgage purposes under S.2560, would achieve the following results:

1. A mortage rate today of 5½ to 6%.

2. Eliminate disintermediation permanently.

3. Reduce inflation in housing costs and in the economy.

4. Stimulate the production of rental housing by the private sector without direct government subsidy while reducing direct Federal involvement and Federal expenditures in providing rental hous

5. Reverse the Federalization of housing.

6. Make single family and rental housing affordable for all Americans.

7. Restore economic health to the Savings & Loan Industry by reducing their average cost of money to far below their average portfolio value, and reestablish the value of their

older low rate mortgages. This would eliminate the need for Federal bail outs and problems of insolvency.

8. Restore employment and create new employment in the housing industry and related industries.

9. Eliminate the cycles in the housing industry and create a more stable economy.

10. Create a choice of higher interest rate commercial deposits for small savers and lower rate tax free accounts for larger savers, related to their marginal tax rate.

A MORTGAGE RATE TODAY OF 5½ TO 6%.

Mortgage rates are ordinarily determined by adding 1½% to 2% to the cost of money. A comparable, to the cost of money under this act, would be HUD construction notes which this month averaged less than 4%. That rate was produced because the interest earned is tax free and backed by the Federal government. Interest earned under S.2560 would be tax free and backed by Federal Deposit Insurance up to $100,000. This should produce a cost of money in the form of deposits approximating 4% with a mark up of 1½ to 2% for residential mortgage rate of 5½% to 6%.

ELIMINATE DISINTERMEDIATION PERMANENTLY.

Depositors, savers, and investors are interested in their best after tax rate of return. They are also concerned about risks involved in their investment. Deposits made under the provisions of S.2560 would not only provide the best after tax rate of return but also by virtue of FDIC Insurance or FSLIC Insurance provide the lowest risk. The rate paid for such deposits would rise or fall with the general money market but would always have an edge in comparison to other savings investments.

REDUCE INFLATION IN HOUSING COSTS AND IN THE ECONOMY.

One of the dominant costs in the production of housing is the cost of money. The increase in interest rates for residential mortgages has been a primary factor in creating inflation in housing. It has not only increased the cost, it has also reduced the production of housing, causing shortages. S.2560 by reducing the cost of money in the form of deposits and thereby reducing mortgage rates, will reduce the cost of housing as a factor in inflation.

Obviously it would also reduce the cost of housing in the CPI and further it would reduce the pressure for increased wages which are essential to purchase shelter.

The basic need for housing through the 80's has been approximated at 2.7 to 3 million units per year. Present Federal Policy has reduced the production of housing thereby accumulating demand. With housing production this year below one million units and demand accumulated at 1.7 to 2 million units it is simple logic that inflation in housing will accelerate in the near future in a classic demonstration of supply and demand.

The only way to reduce inflation in housing and its effect on the economy is to increase the production of housing to meet the demand as determined by demographics. Federal policies have created shortages, accumulated demand, and will create even more inflation in the future cost of housing and its components.

The labor force will again have to ask for continually increasing wages to meet their increased cost of housing. The only way to reduce inflation in housing is by increasing the supply of housing, by reducing interest as one of its primary cost factors, and by breaking the cycle of the housing industry.

There is a shortage of rental housing which is also directly related to the cost of mortgage money. This would be reduced by this bill to a cost lower than existing federal subsidies for rental properties. An increase in the production of rental housing will increase the supply, and under this bill reduce the cost and thereby have a deflationary effect. A detailed explanation follows.

STIMULATE THE PRODUCTION OF RENTAL HOUSING BY THE PRIVATE SECTOR WITHOUT DIRECT GOVERNMENT SUBSIDY WHILE REDUCING DIRECT FEDERAL INVOLVEMENT AND FEDERAL EXPENDITURES IN PROVIDING RENTAL HOUSING.

The production of rental housing by the private sector has diminished because it cannot be produced at a profit.

The increase in interest rates as a cost factor in production of rental housing has eliminated the potential for profit and after tax rate of return required for investment and thereby eliminated production.

Direct federal subsidies have been legislated to create a subsidized mortgage rate of 7½%. S.2560 would provide a rate of interest on mortgages using existing saving institutions that would be lower than the direct federal subsidy and would stimulate an immediate increase in the production of rental housing.

By permitting the private sector through more efficient mechanisms, using existing savings institutions to provide the funding for rental housing, the direct involvement of the federal government would be immediately reduced. Federal expenditures, collecting taxes, and creating and administering direct subsidy programs to stimulate rental housing are obviously more economically inefficient and more expensive than the proposed method of creating the same rental housing. Direct Federal expenditures in rental housing would be reduced as a result of passage of this bill.

REVERSE THE FEDERALIZATION OF HOUSING.

Because the private sector has been prevented from meeting the housing needs of our population by tax disincentives it has been necessary for the federal government to intercede to attempt to meet these housing needs by direct subsidies utilizing tax dollars and increasing Federal expenditures. Recently Mr. Landrieu has proposed that income limitations be totally eliminated for federally subsidized rental housing. Legislation before the congress today would provide for federally subsidized rental housing for tenants having an annual income approaching $25,000 and possibly more. This is a direct result of the tax disincentives for savings and production of rental housing.

The only alternative to giving tax free treatment to savings used for residential mortgage purposes, so as to reduce the cost of mortgages for single family and rental housing, is an increase in the Federalization of the housing industry and housing production. It will be necessary to provide single family and rental housing for our population through the 1980's. The same number of shelter units will be required whether they are provided by the private sector or as a result of direct federal subsidies and federal expenditures.

It would seem obvious and simple that the cost of producing the units will be lower by using a more efficient private sector mechanism with tax incentives for savings and using existing savings institutions, than by collecting tax dollars, creating federal programs and administering these programs to build the same number of shelter units.

The most efficient and effective method to increase the supply of both single family and rental housing in the United States is tax free treatment of savings deposits used for residential mortgage purposes which reduces the cost of money to the lending institutions, and the cost of mortgages to the consumer.

MAKE SINGLE FAMILY HOUSING AND RENTAL HOUSING AFFORDABLE FOR ALL AMERICANS

The changes in banking legislation effective March 31, 1980 have made housing more expensive and less attainable for all Americans. The elimination of Reg. Q. and usury laws, and the creation of a national and international market in money have put housing in a subordinate position to all other investments. Housing must now compete with overseas plant investments, funding the debt of foreign countries, and other investments with a higher rate of return available to our banking community, both national and international.

Money market certificates have enabled the housing sector to compete for funds, but the price of funds has become unaffordable to the consumer of housing.

The key to providing housing for this nation in the 1980's is affordability. The key to affordability for every consumer is the monthly payment. The key to the monthly payment is the mortgage rate and this is determined by the cost of funds in the form of deposits. S.2560 solves the problem.

A six percent mortgage produced today under this bill has a monthly payment on a thirty year schedule of

$6 per thousand, while todays rate of twelve percent costs $10.30 per thousand. On a $50,000 mortgage this represents a reduction in monthly mortgage payments for the consumer of $200 per month. Such a reduction in the cost of living for consumers is deflationary in the area of housing and would be deflationary across the whole economy, since it would be reflected in reduced wage demands.

A comparable reduction in rental housing would be effected.

RESTORE ECONOMIC HEALTH TO THE S. & L. INDUSTRY BY REDUCING THEIR AVERAGE COST OF MONEY TO FAR BELOW THEIR AVERAGE PORTFOLIO VALUE, AND REESTABLISH THE VALUE OF THEIR OLDER LOW RATE MORTGAGES, ELIMINATING THE NEED FOR FEDERAL BAIL OUT AND PROBLEMS OF INSOLVENCY.

Increases in the cost of deposits resulting from federal policies have created a situation where the cost of obtaining new funds have far exceeded the average income from the portfolio of mortgages held by saving institutions. This has led to severe solvency problems within the savings industry and prediction of failures. It has also precipitated the issuance of authority for renegotiable rate mortgages and proposed legislation to authorized mergers.

S.2560 would produce a cost of money far below the average portfolio value and reestablish the value of the older low rate mortgages. This would eliminate the need for Federal bail outs and the problems of insolvency within the Saving & Loan industry.

RESTORE EMPLOYMENT AND CREATE NEW EMPLOYMENT IN THE HOUSING INDUSTRY AND RELATED INDUSTRY.

Present unemployment in the housing industry and related industries has been approximated at one million. The passage of this proposed bill would restore the housing industry and related industries to the level of their prior employment.

In addition it would result in the creation of new employment to meet the unfullfilled need for housing that was unavailable because of tax disincentives and lack of affordability.

The 1979 production of one million eight hundred thousand units is at least a million units short of the estimated annual requirement through the 1980's. Providing an adequate supply of money at a price which a consumer can afford to pay through the tax incentive of S.2560, would enable the housing industry to meet the demographic demand of approximately one million more units per year. This would result in a comparable increase in employment.

A February study by the Congressional Budget Office has established that one percent increase in unemployment, or one million persons unemployed, results in a twenty-two billion dollar reduction in federal income and a seven billion dollar direct expenditure. Restoring the housing industry to its previous level would have a budgetary advantage of twenty-nine billion dollars.

It would appear that the reciprocal of CBO logic should also apply, that a further employment of one percent which approximates one million persons should result in a twenty-two billion dollar increase in federal revenues and a further seven billion dollar reduction in expenditures.

ELIMINATE THE CYCLES IN THE HOUSING INDUSTRY AND CREATE A MORE STABLE ECONOMY

The cycles in the housing industry have been created by disintermediation and by actions of the Federal Reserve Board in driving up interest rates and attempting to control money supply.

These devices used by the Federal Reserve Board have disproportionatly effected the housing industy, and have actually aggravated inflation in housing.

S.2560 would establish an equilibrium relationship between housing and the rest of the economy. The interest rates on mortgages would rise and fall in parallel with other interest rates but within a minimum range of about 4½% to a maximum rate of about 9½%. Although production would decrease as the rates move into higher ranges it would not precipitate the present devestation in housing production and unemployment.

Chairman Janis of the Federal Home Loan Bank Board, in his May speech to the N.A.H.B., suggested tax free treatment of savings targeted to housing, as a method of breaking the cycle. He also stated in response to questions that this might be the only way to make housing affordable by getting under a predicted 10½% floor in future mortgages.

This bill by establishing an equilibrium relationship between housing and the rest of the economy would not only stablize housing but would tend to create a more stable total economy.

CREATE A CHOICE OF HIGHER RATE COMMERCIAL DEPOSITS FOR SMALL SAVERS AND LOWER RATE TAX FREE ACCOUNTS FOR LARGER SAVERS, RELATED TO THEIR MARGINAL TAX RATE.

Under this legislation commercial banks and saving and loans could create commerical accounts on which the depositor would get a higher rate of interest subject to taxation and a residential mortgage savings account which would be tax free. The depositor then could make a choic of accounts. If they were retired or had lower income and paid a lower marginal tax rate they could select a savings account used for commercial purposes which would pay them a higher rate of interest. If because their marginal tax rate were higher and they were seeking an investment or a source of savings deposit which would give them the best after tax rate of return and be risk free, they could select the residential mortgage savings account, tax exempt.

Further the savings institutions could utilize any of the existing forms of deposits whether they be passbook savings, long term CD's or NOW accounts.

The number of housing units required through the 1980's is finite. The amount of money required to produce those units is also finite, it is tied to demographics. It will be necessary to assemble the funds to provide housing either through use of existing private sector institutions or by providing those housing units through the public sector, by collection of taxes and redistribution.

It is submitted that the result which would be produced under S.2560 is not only economically more efficient but would reduce federal expenditures, reduce inflation, and more efficiently and effectively meet the housing needs of this country.

The N.A.H.B. has adopted a Resolution advocating this economic and legislative concept, a copy of which is attached.

W. C. Smith
Franklin Towne Realty, Inc.
7800 Perry Highway
Pittsburgh, PA 15237

NAHB RESOLUTION

May 19, 1980
Washington, D.C.

Special Committee on Taxation

TAX INCENTIVES FOR SAVINGS

WHEREAS, housing affordability is dependent on a supply of money at prices which Americans can afford to pay for home ownership and rental housing; and

WHEREAS, mortgage rates are dependent on the cost of money, in the form of deposits, to the lending institutions,

NOW, THEREFORE, BE IT RESOLVED that the National Association of Home Builders seeks adoption of legislation which will be effective in increasing the supply of savings and reducing the rates of interest paid on residential mortgages by giving tax free treatment to all interest earned on savings deposits which are to be used for residential mortgages.

BOARD OF DIRECTORS ACTION: APPROVED

Senator BYRD. Senator Nelson will preside over these hearing at which the Treasury will testify. I assume they want to testify o the Boren bill and the Nelson bill. Mainly those two. Is that righ Mr. Halperin?

Mr. HALPERIN. I will try to be brief, Senator.

Senator BYRD. This is Mr. Daniel T. Halperin, Deputy Assistar Secretary of Tax Legislation for the Department of the Treasury

STATEMENT OF HON. DANIEL I. HALPERIN, DEPUTY ASSIST ANT SECRETARY FOR TAX LEGISLATION, DEPARTMENT O THE TREASURY

Mr. HALPERIN. Thank you, Mr. Chairman.

I am pleased to be here this afternoon to testify on the 1 miscellaneous bills. I have a statement that I will submit for th record, and try to be brief orally.

The Treasury supports S. 2485 and H.R. 5391, which is one bi that is before you, and unfortunately, we are in opposition to th other 10 that are the subject of these hearings. I would like t make a brief statement on H.R. 5391, but let me first comment jus briefly on what we have heard this morning.

As you are aware, we have felt up to now, at least, that budge ary considerations do not permit major tax cuts, and obviously th Boren bill and Senator Nelson's bill do involve significant potentia revenue losses. Also, when the time comes to consider a tax cut, w believe, as the President has stated, that they should be designed t achieve multiple objectives, not only reducing the tax burden an stimulating growth, but raising investment and productivity an reducing inflation as well.

Obviously, the initiatives that you have heard described this afternoon should be examined when we consider general tax reduction.

However, we do feel that when we examine options for savings incentives, that we should try to do so in a way that would reduce the complex treatment of income from capital that we now have. We now have over $7 billion a year of tax expenditures for savings. They have been creating in an ad hoc, one thing at a time method. We think it is time to take an overall view of this and not continue to pile on these pieces on top of each other.

Senator NELSON [presiding]. Does Treasury have any suggestion on what we can do on that precise point about the $7 billion? Do you have a program proposal?

Mr. HALPERIN. Well, Senator Nelson, when the time comes for tax cuts to be considered, Treasury will have a specific proposal. Obviously, I am not in a position to make any statement on that at this point.

Senator NELSON. One more point. You made reference to inflation. What kind of a response do you have to Mr. Smith's testimony of a few moments ago that by in effect creating a housing shortage, or rather, a housing shortage being created because of a demand for 2.7 million homes a year only being met by a response of 900,000 units, and of course in the marketplace when you are producing a product that is in high demand and in short supply, it is inflationary, and his testimony was you would have inflation of 22 to 25 percent in housing next year, which is horrendous.

He argued that it would be anti-inflationary to move to resolve that problem. What is your comment on that?

Mr. HALPERIN. Senator Nelson, I am not expert enough to know whether those estimates are correct. Obviously, we are concerned with anything that would cause inflationary pressures, and I think that the statement he has made ought to be carefully considered, and all the implications of it ought to be taken into account as we try to develop a program.

One thing that I think is true, both of these proposals are essentially proposals for creating tax-exempt financing in order to put money into the housing market, and you have before you, of course, the issue of mortgage revenue bonds, which raises the same issues. The major difference between the proposals we have discussed this morning and the mortgage revenue bonds are essentially that you don't have the municipality or the State government as an intermediary, but we allow the S&L's or the mutual savings banks to in effect issue their own tax-exempt bonds.

That creates the same problems of inefficiency as we estimate that we lose $1.33 in revenue for each dollar of savings in tax-exempt financing. It creates the problems of competing with the cities and States who will be issuing their own tax-exempt financing, particularly if we are going to allow people to put $100,000 into this account.

I think that the typical buyers of municipal bonds will be substituting this type of account, and I think our feeling has been that at a time when we do have a need for additional capital, that it is not necessarily the most efficient way to allocate it, to allocate it through artificial market forces into housing and away from investments in machinery and other productive equipment.

I think those are complex issues, obviously, and one needs to consider them carefully. I think that you will have an opportunity, I hope, to consider the mortgage revenue bond legislation which has been passed by the House, and I think it would certainly be in order to consider at that point the various proposals that you have heard this afternoon.

Let me just briefly mention H.R. 5391, which is a rather technical bill. In 1969, Congress placed certain restrictions on acts of private foundations, and we have always had the problem of how to enforce restrictions on tax-exempt organizations.

The loss of tax exemption, which is the traditional way of enforcing it, is recognized as a Draconian penalty, often one that is hard to enforce. Therefore, the 1969 act adopted a system of two-tier excise taxes, a rather small tax to act as a deterrent, and a second level tax which in effect would act as an injunction to force correction of the transaction.

For example, if an individual sold property to a private foundation to which he was related, there would be a 5 percent tax on the amount of the selling price. If the transaction were not corrected, the related party would owe the Government 100 percent of the amount involved, and therefore would correct the transaction.

The Tax Court has in effect held that the second-tier tax cannot be applied. For technical reasons, the tax is not assessed until the Tax Court proceeding is over. The Tax Court says therefore there is nothing for it to act on while it is in its meeting.

The bill before you would correct it and have the law operate as it was intended to operate in 1969. We know of no opposition to that legislation, and we would urge that you act on it as expeditiously as possible.

As I say, we have opposed for various reasons the other legislation before you today. My statement describes these reasons, and I would be willing to answer any questions that you might have.

Senator NELSON. I haven't had a chance to look them over, but I would assume that Treasury would be prepared to respond to any written questions submitted to the Treasury on each of these—is it 10 bills?

Mr. HALPERIN. Ten bills, yes.

Senator NELSON. Since I haven't had a chance to review them myself, I won't attempt to make an inquiry, but in the Treasury's testimony you address each and every one of those 10 on the merits?

Mr. HALPERIN. Yes, we do.

[The prepared statement of Mr. Halperin follows:]

For Release Upon Delivery
Expected at 2:00 p.m. EST

STATEMENT OF
DANIEL I. HALPERIN
DEPUTY ASSISTANT SECRETARY OF THE TREASURY
(TAX LEGISLATION)
BEFORE THE SENATE FINANCE
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT
JUNE 24, 1980

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here this afternoon to present the views of the Treasury Department on the eleven miscellaneous tax bills before us today. After setting out a summary of the position of the Treasury Department with respect to each bill, I will discuss each proposal in detail.

The Treasury Department supports H.R.5391 and opposes the remainder of the bills before us today.

S.1614 would permit a private foundation permanently to hold an interest in an independent newspaper by exempting such holdings from the excise tax which generally prevents foundation ownership of a business. The Treasury opposes S.1614. Ownership of a local newspaper is not distinguishable from ownership of other businesses. Allowing a special exception here would open the door to riddling the provision with similar exceptions.

S.2075 would not apply the excise tax for transportation of persons or property by air when use of an aircraft is shared by a labor organization and exempt trust operated for the exclusive benefit of the members of the labor organization. The Treasury opposes S.2075.

S.2493 would extend the period for payment of the manufacturers excise tax on tires, tubes and tread rubber. Treasury opposes S.2493. We believe that all excise taxes should be paid on the same basis.

S.2547, S.2660, and S.2766 all would expand the opportunity for issuance of tax exempt industrial development bonds. S.2547 would permit certain facilities constructed to comply with beverage container laws to be financed with tax exempt bonds. S.2660 permits cities which consist of more than two counties to issue bonds to finance facilities for the furnishing of gas to the city and one contiguous county. S. 2766 would remove all size and ownership restrictions on facilities for the furnishing of hydroelectric power. It would also eliminate the two county rule and the public use test with respect to the issuance of tax exempt bonds to finance such facilities. The Treasury opposes all three measures.

S.2646 excludes from income certain interest earned on savings accounts provided the interest rate is 7% or less and proceeds of such deposits are used to make loans for purchase of a residence or operation of a business or a farm at a rate no more than 2-1/2 percentage points above the deposit rate. Treasury opposes S.2646. Budgetary considerations do not permit major tax cuts at this time. Any future incentives for savings and investment should be designed to result in a more consistent and less complex treatment of income from capital rather than continuing the ad hoc approach we have at present.

S.2757 would expand the DISC provisions and the subchapter S rules in order to accommodate export trading companies. Treasury opposes S.2757.

S.2783 expands the definition of shale oil equipment eligible for the energy tax credit to include equipment used in hydrogenation or a similar upgrading process. Treasury opposes S.2783. The Energy Security Corporation is a better vehicle to determine whether this process requires a subsidy.

S.2784 changes the effective date for amendments made by the Crude Oil Windfall Profits Tax Act of 1980 to allow an investment tax credit for coke ovens put into service before 1980. Treasury opposes S.2784. The provision in question is designed as an incentive to investment and it is not logical to apply it to investment already in place.

H.R.5391 amends the provisions relating to the imposition of second tier taxes on private foundations.

Treasury supports H.R.5391. It is needed to remedy a defect in the statute and permit Congressional intent to be implemented.

S.1614

Exception from Excess Business Holdings Rules for Independent Local Newspaper Business

Under current law, a private foundation's ability to own a business enterprise is limited by the Internal Revenue Code (section 4943). In general, the maximum permitted holdings are twenty percent of the voting stock of the business enterprise reduced by the percentage of voting stock owned by certain related parties referred to as disqualified persons. The amount of permitted holdings is increased to thirty-five percent if effective control of the enterprise is in persons who are not disqualified persons with respect to the foundation. If the foundation's holdings in the business enterprise are increased above the level of permitted holdings other than by purchase by the foundation or by a disqualified person, for example by gift or bequest to the foundation, the foundation has five years within which to bring its holdings down to a permitted level. Special rules provide extended disposition periods for private foundations which had excess business holdings on May 26, 1969. The limitations on excess business holdings apply to all private foundations and to all types of active business except those functionally related to the exempt purpose of the foundation.

S.1614 would exclude an independent local newspaper business from the definition of business enterprise contained in section 4943. An independent local newspaper is defined as a newspaper publication which is not one of a chain of newspapers and which has all of its publishing offices in a single city, community, or metropolitan area, or, on January 1, 1979, within one state.

In effect, the bill would permit a private foundation to own an independent local newspaper business indefinitely, notwithstanding the generally applicable excess business holdings provisions described above. We understand that S.1614 is intended to benefit the Houston Endowment, Inc., a private foundation which owns 100% of the stock of the corporation publishing the Houston Chronicle.

The rationale advanced for the bill is that the estate tax liability of deceased owners of independent local newspapers can be met only if the newspaper is sold and that the only available purchasers are large newspaper chains. The alternative of bequeathing the newspaper business to a private foundation does not change this result because the private foundation must in turn dispose of most of its interest in the business within five years. However, if a private foundation could retain ownership of the newspaper business indefinitely, no forced sale would occur and the existence of a broad-based independent free press would thereby be encouraged.

The Treasury Department opposes S.1614. First, we do not believe that a special exemption from the excess business holdings provisions for independent local newspaper businesses can be justified. These provisions are no more onerous for newspaper businesses than they are for any other type of business. To allow a special exemption for newspapers under an independent free press rationale would open the door to riddling the excess business holdings provisions with similar exemptions. Moreover, the concerns underlying the enactment of the excess business holdings provisions -- and, in particular, the concern that a private foundation which owns a business has an unfair competitive advantage because of its tax exemption and because of its lesser concern with maximizing its profits -- certainly apply to the newspaper business.

Second, we do not agree that the estate tax necessarily forces the estate of the owner of a newspaper business to sell the business. There are a number of estate planning alternatives which could obviate the need for selling the business, including a redemption pursuant to section 303; payment of the estate tax in installments pursuant to section 6166 or 6166A; deferral of the estate tax under section 6161(a)(2); purchase by the owner of sufficient life insurance to pay the estate taxes; borrowing by the estate to pay the estate tax using the stock as collateral; or sale of the stock to an employee stock ownership plan (ESOP) established by the corporation.

Finally, to the extent the estate tax does pose special problems for the owners of businesses, these problems should be addressed by legislation covering all businesses, not by special exemptions for particular types of businesses.

S. 2766, S. 2660 and S. 2547

Tax exempt bonds for hydroelectric power and beverage container facilities and a modification of the term "local furnishing" as applied to facilities furnishing gas

S.2766 would permit the issuance of tax exempt industrial development bonds to provide financing for facilities the primary purpose of which is the generating of hydroelectric power.

S.2547 would permit the issuance of tax exempt industrial development bonds to provide beverage container facilities. For these purposes, the term "beverage container facilities" means the initial supply of refillable beverage containers and shells, plus any facility used by a distributor or bottler of beverages in the collection, sorting, handling or storage of beverage containers, the cleaning and processing of refillable beverage containers, or the manufacture of metal beverage container tops with nondetachable opening devices where required by a beverage container law.

S.2660 would modify the term "local furnishing" as it applies to facilities for the local furnishing of gas to include furnishing to an area consisting of a city and 1 contiguous county.

Treasury opposes S.2766, S.2547, and S.2660. These bills would open the tax exempt market to increased private borrowing. Further, the bills are wasteful, inefficient and overly expensive.

Background

An industrial development bond is a debt obligation issued under the name of a state or local government for the benefit of a private industrial corporation. A typical industrial development bond financing involves a municipality which issues bonds and uses the proceeds to construct a facility; the facility is then "leased" to a corporation for a rental set at the precise amount needed to make the interest and principal payments on the bonds. Characteristically, the bonds are revenue bonds payable only out of the rent; the municipality assumes no obligation, direct or indirect, for their payment. Thus, such bonds really represent obligations of a private corporation, but because the municipality places its name on the bonds, it claims and passes on the federal tax exemption.

In recognition of the economic reality of these transactions, state courts generally agree that these revenue bonds are not debts of the issuing governmental unit for purposes of applying state or local debt ceilings or similar restrictions on municipal borrowing. In some less prevalent situations a governmental unit will issue its general obligation bonds secured by the lease revenues, so that the municipality assumes a subordinate role as a guarantor of the corporate obligation. However, the lease revenues are regarded as the principal security behind the bonds and the use of general obligation bonds does not materially alter the abuses that flow from the transaction.

Prior to 1968, interest on industrial development bonds issued by state and local governments had been exempt from federal income taxation. The use of these bonds had been growing in importance as a mechanism by which state and local governments sought to attract plants to their communities. Through their use, these governments had been able to extend the tax exemption afforded to interest on their securities issued for public investment to interest on bonds issued for essentially private purposes. Of course, as many states and localities came to utilize this method, the competitive advantage was lost and the increased volume of tax exempt financing affected the interest cost of public issues. These factors, and fear of increasing federal revenue losses as use of this method of financing long-term private debt expanded, led to the limits on industrial development bond financing included in the Revenue and Expenditure Control Act of 1968.

In the past few years, the volume of tax exempt bonds issued for nongovernmental purposes -- principally for private residences, private hospitals, pollution control facilities, and various commercial and industrial purposes -- has increased sharply as a share of the tax exempt market. There are indications that this trend is likely to increase and with it the potential for abuse.

A study being conducted by the Congressional Budget Office shows the extent and degree of abuse. It appears that more than $7 billion of industrial development bonds were sold in 1979 to finance such projects as shopping centers, fast-food restaurants, pizza parlors, doctors' offices and even a massage parlor. In many cases, the industrial development bonds are nothing more than a conventional bank loan, rubber-stamped by a local authority. In fact, the borrowing arrangement is almost identical to a commercial loan, except for the official sanction of the industrial development authority. Often, the requisite approval is granted as matter of routine. Under those circumstances, the authority cannot be said to exercise any independent judgment that the borrowing serves a public purpose.

Industrial Development Bonds are an Inefficient Method of Providing a Subsidy

In all cases the exemption from tax of interest on industrial development bonds is simply a federal subsidy to private corporations. The lower interest rates -- which are passed on to the private corporations in the form of lower rental charges -- are only possible because the interest in the hands of the bondholders is tax exempt. The full benefit derived by private industry is achieved only at the expense of a loss of federal tax revenues. Thus, such obligations are in no real sense a vehicle for state aid. Instead, they represent a forced federal subsidy. The amount of the subsidy, the beneficiary of the subsidy, and the use to which the borrowed funds are put are not considered in any way by the federal government. The sole decision as to whether or not to benefit a private corporation rests with the various state and local governments, and since industrial revenue bond financing imposes no direct costs on the issuing governmental units, there is no agency that has any effective interest in assessing the merits of extending federal tax benefits to any particular private corporate beneficiary.

In addition, industrial development bond financing represents a most inefficient and uneconomic means of subsidizing private industry. The cost to the federal government in lost tax revenues substantially exceeds the financial benefits that corporations realize through their ability to borrow funds at lower interest rates. This inefficiency is best illustrated by an example. When the yield on taxable securities is approximately 10 percent, the yield on tax exempt bonds of similar quality will be approximately 7 percent. This means that a borrower who has access to tax exempt financing is able to save thirty cents on each dollar of interest that would normally be paid. On the other hand the average marginal tax bracket for holders of tax exempt securities is approximately 40 percent and, if the interest were not exempt, taxes would have been payable at that rate. This means that Treasury loses about forty cents for each dollar of interest paid on these bonds. In other words, the Treasury loses about $1.33 of revenue for each dollar of incentive provided by tax exempt borrowing. Moreover, the cost to the Federal government will constantly increase as the volume of tax exempt bonds grows larger and interest rates for all tax exempt obligations rise in order to elicit more demand, particularly from relatively lower bracket taxpayers.

Cost to Federal, State and local governments of S.2766, S.2547 and S.2660

Treasury's current estimate of the revenue loss attributable to S.2766 is $370 million for fiscal years 1981 to 1985, assuming that pumped storage facilities are not included under the bill. The current estimate for the loss attributable to S.2547 is $200 million, and for S.2660 $35 million, for the same period. In this time of inflation, when we face an absolute necessity to reduce budget deficits, increasing federal subsidies in this way must be closely examined.

Considerations of tax equity

Tax exempt bonds also raise serious questions of tax equity. The dollar loss in foregone revenues to the Treasury, as described above, is a dollar benefit to the wealthy investors who buy tax exempt bonds. If the ordinary workingman has to pay taxes on his entire paycheck, it is hard to justify an incentive program which provides billions of dollars in tax-free interest for the very wealthy.

Expansion of tax exempt borrowing for hydroelectric power is inappropriate

S.2766 would permit tax exempt financing for facilities the primary purpose of which is the generating of hydroelectric power. S.2766 would, therefore, repeal those provisions of the Crude Oil Windfall Profits Tax Act of 1980 which amended the Code to permit tax exempt industrial development bonds to be issued to provide "qualified hydroelectric generating facilities." Under these provisions, tax exempt industrial development bonds may be issued to finance some or all of the costs of eligible hydroelectric facilities which have an installed capacity not in excess 125 megawatts. In their place, S.2766 would permit tax exempt industrial development bonds to be issued to finance all hydroelectric power facilities, without regard to size or ownership.

Treasury strongly opposes such unrestricted use of tax exempt borrowing. Hydroelectric power facilities are inherently capital intensive. The massive borrowings to finance such facilities will result in a revenue loss to the Treasury. If a subsidy for the generation of hydroelectric power is appropriate, it should be in the form of a direct subsidy administered at the federal level. Otherwise, energy policy with respect to the exploitation of hydroelelctric power will be set by private corporations, operating through the state and local power authorities, rather than by the federal government.

Treasury also opposes S.2766 because it would allow tax exempt financing for hydroelectric power facilities without regard to the "local furnishing" test now applicable to facilities for the furnishing of electrical energy or gas and also because it would set a damaging precedent by eliminating the "public use" test with regard to these facilities.

Under current law, facilities for the local furnishing of electric energy or gas eligible for tax exempt industrial development bond financing are generally limited to those facilities which provide service to the general populace in a service area consisting of no more than two contiguous counties (or their political equivalent). The purpose for this rule is to limit the use of tax exempt industrial development bonds to providing local facilities meeting the needs of the issuer. For qualified hydroelectric facilities that can now be financed with tax exempt bonds, this goal is met by the limitations on the installed capacity of a qualified facility under current law. Such financing may not, therefore, be used for facilities which provide energy for a regional or larger power network. By eliminating the restrictions under current law and removing facilities furnishing hydroelectric energy from the scope of the "local furnishing" rule in all cases, S.2766 creates an untenable distinction between hydroelectric and other forms of electric energy or gas. Ultimately, this will lead to pressure for the elimination of this test in other areas. The result will be an enormous increase in tax exempt borrowing for energy facilities, with a consequent drain on the federal revenues and a squeeze on borrowing for traditional public works projects.

In addition, S.2766 would provide that facilities for the furnishing of hydroelectric power are not subject to the "public use" requirement of current law. This provision of current law requires that facilities which are furnished with tax exempt industrial development bonds serve, or be available on a regular basis to, the general public. Hydroelectric facilities that can now be financed with tax exempt industrial development bonds are expressly subject to this rule. This requirement applies to all so-called "exempt facilities" financed with tax exempt bonds and ensures that such facilities serve some public, as opposed to private, purpose. Tax exempt bonds may be issued without regard to this "public use" requirement only under the "small issue" exemption. No inroads should be made in this requirement.

Tax exempt borrowing for beverage container facilities is unwarranted

S.2547 would allow tax exempt industrial development bonds to be issued to provide "beverage container facilities". This term includes the initial supply of refillable beverage containers as well as processing facilities and facilities for the manufacture of nondetachable pulltabs for beverage containers. A special effective date provision would allow refinancing of existing facilities.

The basic issue posed by S.2547 is relatively straight forward: if a change in plant procedures or operations is occasioned by state or federal law, should a subsidy be provided the affected plant or industry and who should administer that subsidy. S.2547 answers those questions in the case where a state law prohibits or discourages the sale of beverages in nonreturnable containers or containers with detachable pulltabs. It implicitly decides that a subsidy is appropriate and leaves the application and administration of the subsidy up to the state and local governments. The principle it establishes could equally be used to support the issuance of tax exempt industrial development bonds to finance plant alterations to improve safety or to finance the clean up of an environmentally dangerous waste disposal site. The actual decision to grant the subsidy in each case is, however, a matter beyond the control of federal authorities.

Treasury opposes the issuance of tax exempt industrial development bonds for these purposes. In this case, it is a state law which prohibits or discourages certain types of beverage containers. The federal government should not, as a result, be required to provide a subsidy to all affected industries which must retool as a result. Instead, the decision as to a subsidy in each particular instance should be made at the federal, not state, level and only after due consideration to the public interest in providing the subsidy. Under S.2547, no examination is required to determine whether, in a particular case, the subsidy is necessary. All that is required is a state law mandating the change.

In making a subsidy available, consideration should be given to whether the public interest would be better served if the consumers, rather than the general populace, bore the costs of the equipment change. After all, it was the consumer who benefited from the convenience of nonreturnable containers.

In addition, S.2547 may actually discourage the exact behavior it seeks to subsidize. Bottlers which may be affected by a beverage container law now have an incentive to postpone modifications to their bottling operations to utilized returnable containers until required by a beverage container law. If they wait for this change in the law, they will be able to reap the benefits of tax exempt financing for the new facilities. Thus, S.2547 may actually discourage voluntary change by bottlers.

Treasury is especially opposed to S.2547 in its current form. The bill would permit retroactive financing for beverage container facilities where some official action was taken prior to their construction or acquisition and the tax exempt bonds are issued within one year of enactment of S.2547. All that is accomplished by such a provision is to permit the refinancing of taxable debt (or the generation of working capital) at tax exempt rates.

Change in the definition of "local furnishing"

S.2660 would change the definition of "local furnishing" for facilities for the local furnishing of gas. Under current law, the term "local furnishing" means the furnishing of energy to the general populace of a service area consisting of not more than 2 contiguous counties (or their political equivalent). The purpose of this rule is to preserve the local character of the furnishing and to inhibit the volume of tax exempt industrial development bonds used to finance such facilities.

Treasury opposes S.2660. Admittedly, the definition of "local furnishing" for electric facilities under current law contains this exception. There are, however, a great many internal inconsistencies in the industrial development bond provisions and Treasury opposes the fragmentary and piecemeal expansion of tax exempt industrial development bonds represented by S.2660. What is necessary is a thorough reexamination and rationalization of the entire area.

Distinctions between public and private borrowing

Since the adoption of the federal income tax in 1913, interest on state and local government obligations generally has been exempt from federal income tax. This exemption represents a recognition of the independent sovereignty of states and their instrumentalities under our official system as well as the desire to enhance the strength of state and local governments and the entities closest to the people in solving local problems. This rationale applies to all state and local governmental borrowings for public purposes. It does not apply to industrial development bonds, however, because they are merely obligations nominally issued by a state or local government to raise funds for private development.

The only reason for making industrial development bonds tax exempt is to provide a subsidy or incentive. This reason, which is the one underlying S.2547, S.2766 and S.2660 is, for the reasons we have stated, fundamentally unsound. Tax exempt bonds such as those provided in S.2547, S.2766 and S.2660 have considerable drawbacks as a method of providing a subsidy or incentive. They are demonstrably inefficient and inequitable, and they damage the market for tax exempt bonds as a whole.

S.2075

Tax on Transportation by Air-Affiliated Group Exemption

The taxes of 8 percent and 5 percent respectively on amounts paid for transportation of persons and property by air contain an exemption for charges by one member of an affiliated group of corporations to another member if the aircraft is not available for hire by persons who are not members of such group. The taxes also are not levied for transportation by an aircraft having a maximum certificated takeoff weight of 6,000 pounds or less, except when operated on an established line. If exempt from these taxes, the operator of the plane is subject to the 7 cents a gallon tax on fuel used in noncommercial aviation. "An affiliated group" is generally a group of corporations linked with a common parent by 80 percent ownership.

S.2075 would add to the definition of "affiliated group" a labor organization exempt under section 501 and; 1) any trusts exempt under section 501 established for the sole and exclusive benefit of the members of the labor organization and their families and dependents, and 2) any corporation wholly owned by such trusts.[1]

The instant bill is intended to benefit a labor union in Alaska and a series of trusts (pension, medical, legal, etc.) which are jointly administered by the union and employers. The union operates a plane to provide transportation for itself and the trusts. Costs are allocated according to use.

This operation does not qualify for the exemption for an affiliated group because the trusts are not corporations and the union does not "own" or control the trusts.

Under present law the tax imposed on aircraft used to furnish transportation to another for a fee is generally considerably higher than the tax imposed when a corporation or individual owns an aircraft for the owner's own use. We recognize that it may seem inequitable to distinguish between these situations merely on the basis of form. Thus, Congress decided to treat use of a plane by members of an affiliated group of corporations as in effect use by the owner even if the parent owns the plane and charges the subsidiary for its use.

Perhaps other situations call for similar treatment. Nevertheless, the Treasury cannot support S.2075.

In an affiliated group rule there is common control. Moreover, expenses and income of the group can be consolidated in determining liability for income tax. Tax liability should not turn on the choice of operating through more than one corporate entity. The situation in this case is different. The union does not control the operation of the trusts. The union could not itself carry out the functions of the trusts.

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[1] The bill proposes to amend section 4284(b) of the Code. It should be section 4282(b).

Since the union and the trust are in fact separate entities, it is reasonable to treat them as such where one is providing air service for a charge to the other.

Moreover, this amendment would be discriminatory in relation to exempt organizations other than labor unions that might be affiliated with other such organizations. However, expanding the exemption proposed by the bill would present difficult line drawing problems in determining the required degree of relationship once the narrow case of common ownership and eligibility to file consolidated returns is expanded.

S.2493

Time of Payment for Manufacturer's Excise Tax on Tires

S.2493 would provide that the manufacturers excise taxes on sales of tires (10 cents or 5 cents a pound), tubes (10 cents a pound), and tread rubber (5 cents a pound) are to be payable 90 days after the end of the month in which the manufacturer (or importer) sells the article.

Under present law, the Treasury Department has the power to prescribe when most excise taxes are payable. The general rule is that deposit of taxes must be made within 9 days after the end of each semi-monthly liability period. Two exceptions are specified by law. The tax on distilled spirits now is deposited 5 days after the end of each semi-monthly period following the semi-monthly liability period. In 1981 this will be 10 days, and in 1982 and thereafter the last day of the second succeeding semi-monthly period.[1] The tax on fuel used on the inland waterways, which becomes effective in October, provides for a quarterly liability period with payment due by the end of the month following the quarter.

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[1] The payment period for distilled spirits previously was the end of the semi-monthly period following each semi-monthly liability period.

The Treasury Department opposed the extended time prescribed in the law for payment of the excise tax on distilled spirits and fuel used on the inland waterways. We also have opposed the proposed extended period of payment for the tax on fishing equipment embodied in H.R.5505. Our position is that equal treatment of those liable for excise taxes requires that the taxes be paid over at the same time for the different excises.

The argument advanced for specified longer periods of time for individual taxes generally centers around the credit terms of the taxpayers involved. The fishing tackle industry argues that it extends lengthy credit terms so that merchants will buy the products in the fall and winter even though retail sales are slack at this time. This helps fishing tackle manufacturers even out their production schedule. A somewhat similar argument is involved in the case of the instant bill. Tire producers traditionally have provided long credit terms to encourage merchants to keep a full line of tires in stock.

The credit terms of manufacturers are industry and company decisions based on their evaluation of how best to maximize profits. These decisions are not reflected in a firm's need to pay its costs, such as wages, rent, insurance, materials, etc., within the time prescribed by law or contract. There is no reason why excise tax payments should be treated differently than other costs. The taxes should be paid by all firms in the same time frame without regard to credit terms.

The instant proposal would have a significant revenue effect. The taxes on tires, tubes and tread rubber are estimated to raise $835 million in fiscal 1981 under present rules, but the bill would reduce revenues by $190 million in the year of the change. All but a minute amount of the revenue loss would be reflected in transfers to the Highway Trust Fund.1/ In addition to the capital amount, the fund would lose $17 million a year in interest, since interest is paid on the balance in the fund. Or to put it another way, since the balance in the fund is invested in Treasury securities, the Treasury would have to borrow the $190 million revenue loss from other sources with the consequent additional interest cost.

1/ About $1 million of the tire tax revenues are transferred to the Airport and Airway Trust Fund.

Since H.R.5505 can be viewed as a precedent for S.2493, I might point out that H.R.5505 is drafted so that the payments in the last quarter of the fiscal year are bunched in such a fashion that aggregate payments during the year will be the same as under present regulations. But this does not change the fact that any lengthening of the payment period in the interim will result in a cost to the Treasury. The lengthened payment periods permitted by H.R.5505 prior to the fourth quarter would require additional interim Treasury borrowing with consequent increased interest costs to the Treasury.

S.2646

Exemption for Interest Income on Certain Deposits

S.2646 generally would exclude interest income from taxation if the interest rate on the savings is 7 percent or less, the principal is held on deposit for 1 year or more, and the principal is used to make loans with rate of interest no more than 2 1/2 percentage points above the interest rate on deposits. The loan must be used for the purchase of a residence or operation of a business or a farm.

Budgetary considerations do not permit major tax initiatives at this time. However, as the President has stated, "when tax reductions are timely, they should be designed to achieve multiple objectives -- not only reducing the tax burden and stimulating growth, but raising investment and productivity and reducing inflation as well." Therefore, when appropriate, we would like to examine with you various options for tax reduction, including possible incentives for saving and investment.

Meanwhile, let us note some of the difficulties with S.2646, as now structured. Existing tax expenditures for savings and investment total over $70 billion per year, considerably in excess of individual income tax collections on income from capital. The existing plethora of savings and investment provisions in the individual income tax have been adopted over time in piecemeal fashion, and there is no established relationship among these various provisions. We would hope that any future savings incentive would at least result in a more consistent and less complex treatment of income from various forms of capital.

Additionally, any bill which provides an exclusion for interest received should also deal with the deduction for interest paid. Unless this is done a taxpayer who borrows in order to make a deposit in the tax favored account will be able to achieve a tax reduction without any increase in savings.

S.2646 presents some particular difficulties in that it attempts to legislate a limitation in interest rates and to direct loans toward certain types of investment. In so doing, it interferes with normal market activities in several ways. It penalizes savers who can receive rates of return higher than 7 percent. Since higher rates of return act as incentives for savings, taxpayers should be encouraged, not discouraged, to receive the highest rate of return available in the market.

The bill also attempts to use regulation rather than competition to limit rates of interest charged on loans. Enforcement of such a limitation would be difficult. The IRS would need a means not only of checking the rate of interest charged on millions of loans made by institutions, but also of checking which dollar of savings went to which dollar of loan. Such tracking is probably administratively infeasible. It would be more reasonable to let the pressures of competition limit the rates of interest that can be charged on loans. Besides, the appropriate rate of interest is a function of economic conditions and cannot be pegged at a single point for any extended period of time.

If it is desired to reduce the interest cost to particular borrowers, it would be more efficient to do so directly rather than indirectly subsidizing the lender (through a tax benefit) in order to induce him to lend at a lower rate. The approach of the bill increases the waste and inefficiency generally associated with tax-exempt financing.

S.2757

Export Trading Companies

S.2757 is part of an overall legislative effort to bolster U.S. exports through the establishment of export trading companies. Export trading companies are envisioned as a "one stop" facility which can be used by small and medium sized firms to obtain the general expertise necessary to facilitate their export business ventures. S.2718 outlines the non-tax provisions relating to export trading companies while S.2757 provides modifications to DISC and Subchapter S provisions of the Internal Revenue Code with respect to export trading companies.

The Administration is in favor of the adoption of the banking and antitrust provisions of S.2718. However, the Administration remains opposed to the modifications of DISC and Subchapter S provisions proposed in S.2757.

A DISC is generally allowed to defer an incremental portion of its export income. This export income is generated by the DISC through the sales, investment and services performed in connection with its exporting business. Presently, a DISC may receive export income in connection with (1) services related and subsidiary to the sale or other disposition of export property by the DISC, (2) engineering and architectural services for foreign construction projects or (3) managerial services which further the production of export receipts for the DISC. Other service incomes do not qualify for tax deferral under the DISC provision. S.2757 would expand the category of service income entitled to DISC benefits. Under the present DISC provisions a significant portion of export trading companies will qualify for DISC treatment. Thus the creation of export trading companies will effectively expand the number of taxpayers entitled to DISC coverage even if there is not any modification of the qualification requirements of a DISC. However, the extension of DISC benefits to "services produced in the United States" and to "export trade services" could create substantial revenue loss, which the present budgetary restrictions simply would not permit. We note in particular the vagueness and uncertainty of these terms.

Even if Federal budgetary conditions were less stringent, we have serious doubts as to whether the intent of the legislation to encourage exports would be achieved by providing such DISC benefits. Many of our large international service firms would incorporate as an export trading company simply to qualify for DISC benefits provided by S. 2757. The result would be a substantial revenue loss without demonstrable growth in U.S. exports.

Finally, we note that under the recently negotiated International Subsidies Code, the U.S. was able to secure at least a temporary "grandfathering" of the present DISC program. Substantial expansion of the DISC program would raise questions about U.S. observance of our international obligations.

With respect to the Subchapter S provisions, we support the elimination of the present requirement that a qualifying corporation earn at least 20 percent of its income within the United States. However, we believe that this change should be part of a broader reform of Subchapter S. We call the Committe's attention to the report on Subchapter S reform recently issued by the Joint Committee on Taxation and urge the tax writing Committees to consider these reforms as soon as it is feasible. We do not, however, favor allowing corporate shareholders in Subchapter S corporations.

For these reasons the Administration opposes S. 2757.

S.2783

Expansion of Energy Tax Credit for Shale Oil Equipment

The Energy Tax Act of 1978 provided a 10 percent energy tax credit for shale oil equipment for property placed in service and expenditures incurred through December 31, 1982. In addition, the credit may be available after 1982 for certain long-term projects upon which substantial progress has been made before that date.

The term "shale oil equipment" includes equipment for producing or extracting kerogen (shale oil) from oil shale. The extraction process is known as "retorting." The term "shale oil equipment" does not include equipment for hydrogenation, refining or other processes subsequent to retorting. Hydrogenation is necessary to produce pipeline quality crude oil from kerogen. This limitation is similar to that for percentage depletion, which provides that gross income for depletion purposes does not include any increment in value attributable to hydrogenation or any other process subsequent to retorting.

The Treasury Department is opposed to enactment of this provision because no material expenditures for hydrogenation can be expected to be incurred before 1984-85. At that time the Energy Security Corporation will be functioning and will be better able to determine whether this process requires a subsidy as well as the type of subsidy required (grant, loan, loan guarantee, etc.).

S. 2783 is estimated to have a revenue cost of $74 million in 1985.

S.2784

Energy Tax Credit for Coke Ovens -- Effective Date

Under the Crude Oil Windfall Profit Tax Act of 1980, Congress provided a 10 percent energy investment tax credit (in addition to the regular 10 percent credit) for coke ovens. This provision, which was effective January 1, 1980, was adopted despite Administration objections that the tax subsidy would not induce additional energy savings. S.2784 changes the effective date to periods after September 30, 1978.

Even if we were to accept the contentions of the sponsors of S.2784 that coke oven construction will conserve oil and gas, there cannot be any savings attributable to a retroactive credit since the investments in the property have already been made. A provision intended to act as an investment incentive should only apply prospectively.

The revenue loss from adoption of S.2784 will total $53 million for calendar years 1981 and 1982.

H.R.5391 AND S.2485

Second Tier Excise Tax on Prohibited Acts of Certain Tax-Exempt Foundations and Trusts

H.R.5391, the "Chapter 42 Second Tier Tax Correction Act of 1980," and S. 2485, an identical bill, attempt to remedy a procedural defect in the current two-tier excise tax system applied to certain acts, or failures to act, by private foundations, employee retirement trusts, and Black Lung Benefit Trusts. We believe it is important to remedy the defect in the statute and we support the passage of these bills.

Current Law

Private foundations, employee retirement trusts and Black Lung Benefit Trusts are subject to certain restrictions and requirements. The two-tier excise tax system attempts to enforce these requirements and restrictions in two ways. First, it seeks to deter violations by automatically imposing a small excise tax on the prohibited act or the failure to act. Second, it seeks to restore the status quo by imposing a substantial second-tier tax if the prohibited act, or failure to act, is not corrected. The problem which has arisen and which is intended to be corrected by H.R. 5391 and S. 2465 relates to the imposition of the second-tier excise tax in certain circumstances.

Purpose of System

The problem may be illustrated by focusing on the private fondation self-dealing provisions. Before 1970, if a private foundation and a related person engaged in a prohibited self-dealng transaction, the penalty imposed was loss of the private foundation's tax exemption for a minimum of one year and the loss of charitable contribution deductions under certain circumstances.

In 1969, Congress developed the approach of imposing excise taxes for engaging in a prohibited activity rather than penalizing the foundation directly by loss of its exempt status. Under the Code, any act of self-dealing between a private foundation and a "disqualified person" (generally, any party with a substantial interest in the foundation) is prohibited. If such an act takes place, an excise tax equal to five percent of the "amount involved" (generally, the greater of the amount of money and the fair market value of the property given or received) is imposed on the disqualified person.

In addition to changing the focus of the penalty from the private foundation to the disqualified person, the excise tax system was structured to encourage the correction of prohibited acts so that a private foundation would be in essentially the same position after the correction as it would have been if the prohibited act had not occurred. This is achieved by imposing a substantial second-tier tax if the prohibited act is not corrected within "the correction period." In the area of private foundation self-dealing, the second-tier excise tax is 200 percent of the amount involved. In most cases, correction involves undoing the transaction to the extent possible, but in any case placing the private foundation in a financial position not worse than what it would have been in if the disqualified person had dealt with the foundation under the "highest fiduciary standards."

Description of Problem

The problem addressed by H.R.5391 and S.2485 has arisen in connection with the relationship between imposition of the second-tier tax and the definition of the correction period. Under current law, the second-tier tax is not imposed unless the correction period has expired, but the correction period does not end until the Tax Court decision becomes final.

In recent cases, the Tax Court has held that, since the second-tier tax is not "imposed" at the time the taxpayer's petition is filed with the Tax Court, there is no deficiency for the Tax Court to consider. Such a result vitiates the second-tier tax and substantially reduces the incentive for voluntary compliance with the correction requirement.

H.R.5391, as passed by the House of Representatives on May 20, 1980, and S.2485, an identical bill introduced by Senator Long on March 27, 1980, would resolve the problem faced by the Tax Court by treating the tax as being "imposed" if the act or failure to act is not corrected within the "taxable period." In general, the taxable period would end when the Internal Revenue Service mails a notice of deficiency for the first-tier tax even though a Tax Court petition is filed.

Under this approach the Tax Court would have jurisdiction over the alleged deficiency of the second-tier tax by the Internal Revenue Service since the tax would be imposed as required by the Tax Court jurisdictional standards.

In addition, the bill would continue to allow a prohibited act or failure to act to be corrected throughout the period in which the taxpayer may seek Tax Court review of the determination made by the Internal Revenue Service.

Senator Nelson. All right. If there are additional questions on it, we will submit them to you to be responded to for the record. Is that all you had?

Mr. Halperin. Yes, sir. Thank you.

Senator Nelson. There is a Democratic conference scheduled in S. 207 at 3 o'clock which I have to attend. Senator Gravel will be back here at 4 o'clock to continue the hearings. We will recess until 4 o'clock.

[Whereupon, a brief recess was taken.]

Senator Gravel. The hearing will come to order.

I will hear the balance of the witnesses but if the witnesses will forgive me, I will show preference and priority to those who have traveled the furthest distance.

The first group of witnesses will deal with the subject of tax-exempt financing for hydro. I would like to call up Mr. Eric Yould to give his testimony on the subject, and anybody he wishes to have accompany him.

I will not show preference to my people from Alaska, and that will be to enforce the 5-minute rule on everybody.

Mr. Yould, a pleasure seeing you again. Please proceed.

STATEMENT OF ERIC YOULD, EXECUTIVE DIRECTOR, ALASKA POWER AUTHORITY

Mr. Yould. Mr. Chairman, thank you for the opportunity. I do have written comments and I would like these entered into the record.

Senator Gravel. It will be entered into the record as presented.

Mr. Yould. If I may, I can just summarize.

Senator Gravel. Please.

Mr. Yould. The Alaska Power Authority is here to testify in favor of Senate bill 2766 which, as I understand, would eliminate what we in the power industry call the local furnishing rule, which precludes tax-exempt financing for developing certain projects.

Basically, what the local furnishing rule says is that if more than 25 percent of the power from a project is to be provided to a nongovernmental entity, then all of that power must be marketed within two contiguous counties or political subdivisions; otherwise, the bonds sold to finance a project would themselves be taxable.

The effect would be, on a typical project, a spread on the interest rate of maybe 5 percent between a taxable bond and a tax-exempt bond.

Now, the rule grew out of a congressional definition of local furnishings that was passed by the Congress in 1968; a period of time when we apparently had tremendous abundance of not only hydropower, which this bill deals with, but also coal, oil, gas, and nuclear potential.

Let me give you the effect that this had on the industry up to that period of time. Considering the 5-percent differential between a taxable bond and a tax-exempt bond, let's consider two cases, one an oil-fired generation facility and one a hydropower generation facility, both being able to produce the same equivalent amount of energy.

The point is the capital investment associated with that oil-fired generation represents only 10 to 30 percent of the total cost of that power generated. Compare that to the hydropower project, in which the capital cost represents roughly 90 percent of the power generation cost delivered to the consumer, and you can see that the 5-percent differential applied to the diesel plant represents a relatively small portion of the consumers electrical bill in comparison to that when it is applied to the hydro powerplant.

Thus, the effect has been to give a disproportionate advantage to the fossil fuel generation resource and has discouraged the development of renewable resources such as hydropower. Consequently, I think that the bill being considered today is very much in consonance with the Federal policy toward getting off fossil fuel fire generation and on to renewable resources such as hydropower.

Senator GRAVEL. Would you explain that advantage again? I think that is a very critical point. If you have a diesel plant and you are within one county, in which it is easier to use diesel plants and you could put diesel plants in each county you could then sell tax-exempt bonds.

Mr. YOULD. Correct. But you could even with hydropower, as long as it was all delivered to one or two contiguous counties. But the point is that if you want to transport that power over more than two contiguous counties, then you are into a taxable situation, in which case that 5-percent tax differential is applied against a capital cost for the diesel plant, for instance, of only 30 percent of the total cost of energy, versus 90 percent for this renewable resource which has no fuel component whatsover.

So you have actually discouraged the development of renewable resources by the passage of this particular bill that was promulgated in 1968. S. 2766 will alleviate that problem.

Now, it is my understanding that the Congress has recently considered appropriating up to $20 billion for synfuel development, that this will help provide the transition over to a synthetic fuel type energy development, and that this technology itself is to back out the use of oil, gas, nuclear; but in fact, this in itself is a risky technology, one which might or might not work, and hence you don't know if you are even going to get a return on your investment for the $20 billion that you are considering appropriating.

In fact, hydropower is a proven technology, it is one that does not require additional technological developments, it is one in which we could significantly and directly back out of the economy the oil which is causing the inflationary problems which we have today.

As one example, Mr. Chairman, the Alaska Power Authority is in the process right now of completing an assessment of the economic and environmental desirability of developing the Susitna hydropower project, which would provide energy to roughly two-thirds of the State of Alaska, Anchorage and Fairbanks primarily.

The project would develop some 6 billion kilowatt hours annually, which has the energy equivalent of some 10 million barrels of oil per year. That is oil that will be diverted from the State of Alaska for use within the remaining 49 States.

Now, 10 million barrels of oil per year does not sound like much, but when you consider the fact that this project will be generating for at least 100 years and very probably considerably longer than that, then over that 100-year period of time, that energy that is produced is equivalent to roughly one-tenth of Prudhoe Bay itself.

Now, what do you suppose the equivalent value of one-tenth the oil of Prudhoe Bay is? You are talking about roughly 1 billion barrels of oil. At a spot market or an average OPEC price of $30 per barrel, the $3 billion investment in Susitna will have a present-day value of $30 billion worth of fuel disbursed to the lower 48 and these funds will remain in the United States, rather than being sent to OPEC countries.

This hydropower itself will have no greenhouse effect worldwide; it will have no acid rain; it will provide no sludge, no black lung disease, no radiation problems; and yet it is a technology that is available today. There is no doubt that there are problems with hydropower, but on a project-by-project basis and with proper environmental safeguards, it can be made environmentally benign.

Treasury has in the past opposed tax-exempt financing for hydropower. In fact, they are worried about the cost to the Treasury. But my point is that without tax-exempt financing, many of the hydropower projects that could be developed would not be developed because of the disproportionate advantage that tax exemption has on renewable resources versus the fossil fuel fired plants that I mentioned earlier.

In addition, Treasury loses sufficient revenue when oil is purchased from foreign sources rather than developing its own renewable resources.

The development of hydropower, I would say, with tax exempt financing is not precedent setting, primarily because it does represent a capital intensive industry. The hydroprojects themselves have a huge front end cost, and virtually no electric or fuel cost thereafter. This is distinct from virtually all the other electric generation projects. Both these factors make financing of hydro far more difficult than other energy resources and necessitate the governmental support.

Mr. Chairman, hydropower, I think, along with other renewable resources, is an investment in the future. It is a legacy for our country. It is noninflationary. I think if Treasury actually weighed the benefits of developing this renewable resource against what I perceive as miniscule or revenue not going to Treasury, that we would find there is a significant cost benefit to developing this renewable resource.

This concludes my testimony.

Senator **GRAVEL**. Thank you very much, Mr. Yould. I have enjoyed a couple of the points which you made that I had not thought of. Thank you.

Mr. **YOULD**. Thank you, Mr. Chairman.

[The prepared statement of Mr. Yould follows:]

TESTIMONY OF MR. ERIC YOULD,
EXECUTIVE DIRECTOR,
ALASKA POWER AUTHORITY
REGARDING S2766, "THE HYDROPOWER DEVELOPMENT ACT OF 1980."

BEFORE THE SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT
SENATE FINANCE COMMITTEE

JUNE 24, 1980

MY TESTIMONY TODAY ADDRESSES THE IMPORTANCE OF TAX EXEMPT FINANCING FOR ALL HYDROELECTRIC FACILITIES. I WILL BRIEFLY EXPLAIN THE EXISTING LAW, THE CONFLICTS OF THE PRESENT LAW WITH NATIONAL POLICY, AND THE IMPACTS ON ELECTRIC POWER CONSUMERS IN ALASKA.

SECTION 103 OF THE INTERNAL REVENUE CODE ALLOWS STATES AND THEIR POLITICAL SUBDIVISIONS TO ISSUE BONDS ON WHICH THE INTEREST PAID BY THE ISSUER IS EXCLUDABLE FROM THE GROSS INCOME OF THE RECIPIENT. THIS GENERAL PROVISION, HOWEVER, DOES NOT APPLY TO INDUSTRIAL DEVELOPMENT BONDS (IDB's). IDB's ARE ANY OBLIGATION ISSUED (A) FOR WHICH ALL OR A MAJOR PORTION OF THE PROCEEDS ARE USED DIRECTLY OR INDIRECTLY IN ANY TRADE OR BUSINESS CARRIED ON BY A NON EXEMPT PERSON AND (B) THE PAYMENT OF PRINCIPAL AND INTEREST ON THE OBLIGATIONS IS SECURED BY ANY INTEREST IN PROPERTY OR IS TO BE DERIVED FROM PAYMENTS IN RESPECT OF PROPERTY, USED OR TO BE USED IN A TRADE OR BUSINESS. AN "EXEMPT PERSON" IS DEFINED AS A GOVERNMENTAL UNIT OR TAX EXEMPT CHARITABLE ORGANIZATION. A PUBLIC UTILITY IS THEREFORE AN EXEMPT PERSON, WHEREAS A PRIVATE UTILITY OR AN ELECTRIC COOPERATIVE WOULD NOT BE AN EXEMPT PERSON. THEREFORE, BONDS ISSUED TO FINANCE A POWER PROJECT WOULD BE CLASSIFIED AS INDUSTRIAL DEVELOPMENT BONDS IF TAKE OR PAY POWER SALES CONTRACTS WITH PRIVATE OR COOPERATIVE UTILITIES PROVIDE FOR PURCHASE OF MORE THAN 25% OF THE OUTPUT OF THE PROJECT AND PAYMENTS BY THE NON-EXEMPT PERSONS EXCEED MORE THAN 25% OF THE TOTAL DEBT SERVICE OF THE OBLIGATIONS.

THE INTEREST ON SUCH IDB's WOULD BE TAXABLE TO THE RECIPIENT UNLESS THE PROJECT COMES WITHIN AN EXEMPTION FOR "FACILITIES FOR THE LOCAL FURNISHING OF ELECTRIC ENERGY". LOCAL FURNISHING MEANS AN AREA COMPRISING MORE THAN TWO CONTIGUOUS COUNTIES, OR ONE CITY AND A CONTIGUOUS COUNTY.

NATIONAL ENERGY POLICY TODAY IS AIMED AT DECREASING PRESENT DEPENDENCE ON FOREIGN OIL AND NATURAL GAS THROUGH CONSERVATION, INCREASED U.S. PRODUCTION, AND DEVELOPMENT OF ALTERNATIVE ENERGY RESOURCES. THIS POLICY, IF SUCCESSFUL, WILL DECREASE OUR BALANCE OF PAYMENT PROBLEMS AND CONTRIBUTE TO THE CONTROL OF INFLATION WITHOUT RECESSION.

CURRENT TAXATION OF OBLIGATIONS ISSUED TO FINANCE HYDROELECTRIC AS WELL AS DEVELOPMENT OF VIRTUALLY ALL RENEWABLE RESOURCE PROJECTS DEFEATS THIS ENTIRE PROGRAM. CAPITAL INTENSIVE PROJECTS WHICH CANNOT BE FINANCED ON A TAX EXEMPT BASIS PRODUCE ENERGY WHICH COSTS 50% MORE TO THE CONSUMER THAN ENERGY PRODUCED BY PROJECTS WHICH ARE ELIGIBLE UNDER THE LAW FOR TAX EXEMPT STATUS. MANY PROJECTS WILL NEVER BE DEVELOPED BECAUSE OF THE EXISTING REGULATIONS PERMITTING THIS COST IMPACT ON THE CONSUMER. CONSEQUENTLY, NATIONAL ENERGY POLICY IS THWARTED AS UTILITIES CONTINUE TO BUILD GENERATION CAPACITY WHICH BURNS FOSSIL FUELS. THE CONSUMERS

SAVE IN THE SHORT TERM, BUT THEY LOSE AS DOES OUR NATION IN THE LONG TERM. WE WILL CONTINUE TO IMPORT FOSSIL FUELS, WE WILL CONTINUE TO DEGRADE OUR AIR QUALITY, WE WILL BE PERMITTED TO UTILIZE TAX EXEMPT FINANCING FOR POLLUTION CONTROL FACILITIES ON CONVENTIONAL GENERATION SYSTEMS, WE WILL CONTINUE TO EXPORT U.S. DOLLARS, WE WILL CONTINUE TO ATTEMPT TO FIGHT INFLATION IN EVERY SECTOR OF OUR ECONOMY, WHICH LIKE IT OR NOT, IS DEPENDENT TO SOME DEGREE ON ENERGY, AND WE WILL CONTINUE TO WORRY ABOUT RECESSION AS LONG AS TAX POLICIES RESTRICT ALTERNATIVE ENERGY DEVELOPMENT SUCH AS HYDROPOWER.

ALL UTILITIES, WHETHER PUBLIC, NON-PROFIT COOPERATIVES, OR PRIVATE, PROVIDE A PUBLIC SERVICE AND SERVE THE GENERAL PUBLIC. NON-PROFIT REA COOPERATIVES ARE LIKE PUBLIC UTILITIES EXCEPT THAT THEY ARE REGULATED BY STATE PUBLIC UTILITY COMMISSIONS, THEY OFTEN SERVE RURAL AREAS WHICH RESULTS IN HIGHER COSTS OF SERVICE, AND THEY ARE ELIGIBLE IN VARYING AMOUNTS FOR FEDERAL LOW INTEREST LOANS AND GUARANTEE PROGRAMS. PRIVATE OR INVESTOR OWNED UTILITIES ARE ALSO REGULATED BY PUBLIC UTILITY COMMISSIONS, AND THEIR MARGIN OF PROFIT IS REGULATED AS A FAIR RETURN ONLY ON EQUITY. THEREFORE, THE BENEFITS OF TAX EXEMPT FINANCING TO ALL THREE TYPES OF ELECTRIC UTILITIES WILL ONLY FLOW TO THE ELECTRIC CUSTOMERS.

WHAT IF THE CUSTOMERS ARE LARGE INDUSTRIAL OR COMMERCIAL CONSUMERS? THE LAW ALSO DISCRIMINATES HERE. THE LARGE PRIVATE CUSTOMER CAN OFTEN LOCATE WITHIN THE SERVICE AREA OF A PUBLIC UTILITY. IT CAN LOCATE IN A REGION OF THE COUNTRY WHERE ABUNDANT LOW COST ENERGY WAS AVAILABLE IN THE PAST DUE TO LARGE HYDROELECTRIC PROJECT DEVELOPMENT ENCOURAGED BY THE FEDERAL GOVERNMENT IN WISER TIMES. THE TENNESSEE VALLEY AND THE PACIFIC NORTHWEST ARE PRIME EXAMPLES. OR IT CAN PRODUCE ITS OWN POWER FINANCED WITH TAXABLE BORROWING AND DEPENDENT ON FOSSIL FUELS, AND PASS THE CONSTANTLY INCREASING COSTS ON TO ITS CONSUMERS WHICH CONTRIBUTES TO INFLATION. AN INDUSTRIAL CUSTOMER CAN ALSO LOCATE IN A SERVICE AREA WHICH CONSUMES A LARGE AMOUNT OF POWER, THEREBY ELIMINATING THE RESTRICTIONS IMPOSED BY THE "TRADE OR BUSINESS TEST" WHICH PROHIBITS THE CONTRACT FOR THE PURCHASE OF OVER 25% OF THE OUTPUT OF A PROJECT BY A NON-EXEMPT PERSON. IN ADDITION, INDUSTRIAL AND LARGE CONSUMERS ARE THE FIRST TO HAVE CURTAILMENTS OF SERVICE WHEN A SHORTAGE OF POWER EXISTS IN ORDER TO MAINTAIN AMPLE POWER SUPPLY TO THE RESIDENTIAL CONSUMERS.

THE EXEMPTIONS FOR TAX EXEMPT FINANCING OF ALL HYDROELECTRIC PROJECTS PROVIDED BY THE LEGISLATION CONSIDERED HERE TODAY IS CONSISTENT WITH NATIONAL ENERGY AND ECONOMIC POLICY AND IS IN THE PUBLIC INTEREST. IT DOES NOT REMOVE ANY OF THE APPLICATION OF THE IRS REGULATIONS FOR POWER PRODUCTION

BY ANY CONVENTIONAL MODE OF FOSSIL FUELS GENERATION. IT ONLY ENCOURAGES THE USE OF A VALUABLE RENEWABLE ENERGY RESOURCE. AND THIS DEVELOPMENT CAN ONLY TAKE PLACE SUBJECT TO THE SAME CLOSE SCRUTINY AND APPROVAL OF ENGINEERING SAFETY AND ENVIRONMENTAL IMPACTS PRESENTLY EXERCISED BY THE FEDERAL ENERGY REGULATORY COMMISSION.

THE ENERGY SITUATION IN ALASKA

ALASKA IS FORTUNATE TO CONTAIN AN ABUNDANCE OF ENERGY RESOURCES OF ALL TYPES. THE TREMENDOUS NUMBER OF RIVERS, LAKES AND STREAMS CONTAINS ALMOST ONE-HALF OF THE HYDROELECTRIC POTENTIAL REMAINING UNTAPPED IN THE ENTIRE NATION. DEVELOPMENT OF BUT TWO PERCENT OF THIS POTENTIAL FOR INSTATE USE WOULD PROVIDE FOR OUR NEEDS INTO THE 20TH CENTURY.

CURRENTLY, THE STATE IS PROCEEDING FORWARD WITH PLANNING OR CONSTRUCTING MORE THAN TWENTY HYDROELECTRIC PROJECTS. THE OUTPUT OF THESE FACILITIES RANGES FROM A SMALL 1/10 MW TO 30 MWs OF INSTALLED CAPACITY. ALL OF THESE PROJECTS HAVE ONE THING IN COMMON. THEIR REMOTE LOCATION, LOW ENERGY DEMAND, INCLEMENT WINTER WEATHER CONDITIONS AND DIFFICULT TERRAIN HAVE STIFLED THE DEVELOPMENT OF ELECTRIC TRANSMISSION GRIDS, THEREFORE, ALL THESE COMMUNITIES HAVE THE UNIQUE ADVANTAGE OF COMPLYING WITH ALL SMALL PROJECTS CURRENTLY UNDERWAY WILL REPLACE INTERNAL COMBUSTION DIESEL GENERATORS IN THESE ISOLATED RURAL TOWNS AND VILLAGES OF THE STATE.

IN THE FUTURE, OUR STATE WILL CONTINUE THE DEVELOPMENT OF HYDROELECTRIC POWER AS ALLOWED BY THE IRS REGULATIONS. REGRETFULLY, OUR LARGEST POPULATION CONCENTRATION IS LOCATED IN AN AREA OF SOUTHCENTRAL AND INTERIOR ALASKA AND COULD MOST EFFICIENTLY BE SERVED BY CONSTRUCTING A 1400 MW HYDROELECTRIC PROJECT ON THE SUSITNA RIVER. FINANCING PROBLEMS ARISE WHEN 1) THE PROJECT VIOLATES THE TWO COUNTY RULE AND 2) FOUR OF THE SIX UTILITIES IN THE REGION ARE REA COOPERATIVES (A NON-EXEMPT PERSON).

THE DIFFERENT UTILITIES MUST THEREFORE CONTINUE BURNING NATURAL GAS, OIL AND COAL IN THEIR EVER GROWING NUMBER OF THERMAL GENERATORS. TO ASSIST THE RATEPAYERS THE FEDERAL GOVERNMENT ALLOWS THE 2 MUNICIPAL UTILITIES TO FINANCE TAX-EXEMPT AND FOR THE CO-OPS, THE FEDERAL GOVERNMENT LOANS MONEY AT SUBSIDIZED RATES. HOWEVER, NONE OF THE INDIVIDUAL UTILITIES CAN UNDERTAKE A PROJECT OF SUSITNA'S MAGNITUDE. ONLY THROUGH COMBINING THEIR RESOURCES CAN THE PROJECT BE A REALITY AND THEN ONLY IF TAX EXEMPT FINANCING IS PERMITTED.

AT AN ESTIMATED COST OF $3,000,000,000 THE AVERAGE COST OF FIRM POWER FROM SUSITNA IS $2200/KW. WITH TAX EXEMPT FINANCING, AT AN ESTIMATED 8% RATE OF INTEREST AND A 40 YEAR MATURITY, THE WHOLESALE COST OF POWER TO THE INDIVIDUAL UTILITIES WILL BE APPROXIMATELY 67 MILLS (6.7 cents)/KWH. CONVERSELY, WITH A 12% TAXABLE INTEREST RATE, THE UTILITIES WILL PAY OVER

100 MILLS ($.10)/KWH. THE SIGNIFICANT POINT IS THAT THE COST OF THIS POWER WILL NOT INFLATE AS WILL ITS FOSSIL FUEL FIRED COUNTERPART; THUS STRENGTHENING OUR STATE AND NATIONAL ECONOMIES. TO THESE WHOLESALE RATES MUST BE ADDED ALL DISTRIBUTION COSTS. HOWEVER, WITHOUT TAX EXEMPT BONDS, SUSITNA WILL NOT BE DEVELOPED AND WE WILL CONTINUE TO BURN FOSSIL FUEL EQUIVALENT OF 10,000,000 BARRELS OF OIL ANNUALLY.

IN CONCLUSION, THE HYDROPOWER DEVELOPMENT ACT OF 1980 WOULD RESOLVE THE PROBLEMS OF TAX-EXEMPT HYDROELECTRIC FINANCING THROUGHOUT THE NATION AND CONTRIBUTE TO A SOUND NATIONAL ENERGY POLICY. TO DO LESS THAN ELIMINATE THESE REGULATORY BARRIERS, WILL PRECLUDE THE NATION FROM USING OUR MOST RENEWABLE, NON POLLUTING RESOURCE - FALLING WATER, THE MOST EFFICIENT FORM OF SOLAR POWER GENERATION.

THANK YOU FOR THE OPPORTUNITY TO SPEAK BEFORE YOU TODAY AND FOR YOUR ATTENTION.

Senator GRAVEL. Our next witness is Dr. Gordon Marker, president, National Alliance for Hydroelectric Energy.

Dr. Marker, would you introduce your colleague also for the record?

STATEMENT OF DR. GORDON MARKER, PRESIDENT, NATIONAL ALLIANCE FOR HYDROELECTRIC POWER, INC., ACCOMPANIED BY JAMES BRODER, COUNSEL

Dr. MARKER. Yes, this is Mr. James Broder, who is counsel to the National Alliance for Hydroelectric Energy.

We have prepared a written statement which we would like to submit for the record.

Senator GRAVEL. It will be placed in the record as submitted.

Dr. MARKER. In view of the limited amount of time, we would like to highlight several points. The National Alliance for Hydroelectric Energy is a trade association and has recently been formed for the purpose of essentially uniting a rather dispersed constituency in the growing hydroelectric energy area.

It is composed of small developers, manufacturers, the financial community, site owners, architectural and engineering firms. In its short history to date, it has been involved with the windfall profit tax research end of activity, supplying information to the joint committee staff.

In addition, there has been a conference which the National Alliance has conducted which was quite successful as a kickoff for the alliance.

I think Mr. Yould has made an excellent statement, which we can only second, on the signficance of hydropower and also the positive aspects of the proposed legislation. We would like to address a couple of questions. The first one is: Why tax exemption now?

I think that if we are serious about import substitution and oil displacement, then we have to look at a range of additional incentives that can implement this process more rapidly. The New England River Basin Commission has recently completed a study which I think is quite instructive.

They have developed a scenario of looking at economically feasible sites for New England alone. They have come up with a scenario which addresses what would likely happen at market rates of interest and what would likely happen at Treasury rates of interest. The spread is 7 percentage points.

The implications of this impact, I think, are instructive. The number of sites that would be developed in the next decade or so, in effect the tax exemption rate would be 209, more or less, as opposed to about 80 at market rates. The additional megawattage would be 466 megawatts in New England alone, in contrast to 164 at market rates of interest.

The additional output per year would be in excess of three times. Now, this is for New England alone, and it is only for existing facilities. What does it translate into in addition to these energy dimensions? It means new investment of about $450 million, new investment in hydro at existing dams.

The induced economic activity that would follow from this is on the order of $1.2 billion. The jobs would be probably on the order of 4,500 man-years of construction activity. Now, this is for one region, and what we are looking at is the differential impact of the sort of incentive that the tax exemption would carry with it.

A second question: Why won't rising oil prices be adequate alone to create the incentive for hydropower? I think the answer here is negative. The pricing of energy in a utility distribution area is based on a combination of fuels. So the impact of an OPEC rise in prices will be very dampened by the very fact that that impact is mixed in with a variety of other energy sources.

More important, however, is the delay of the impact between any given price increase in fossil fuel or, more particularly, in oil. There will be a delay in the impact on ratemaking, and consequently, on the incentive structure in the industry generally.

I think the issues here are that, one, we have to look at what the impact is on the investment decision. I would suggest that a lower interest rate which is known now as a result of passage of S. 2766 is of greater significance than an anticipated but unknown price rise in the future.

Second, I think the substitution of hydro for oil, which can be done and which can be implemented quickly, requires a set of national incentives that will accelerate hydro implementation. I think that the present policy of laissez faire in this matter simply won't do, given the gravity of our situation.

Therefore, the National Alliance strongly endorses Senate bill 2766 to include all of hydro. Thank you.

Senator Gravel. Thank you very much.

[The prepared statements of Dr. Marker and Senator Gravel and Booz Allen & Hamilton, Inc., follow:]

REMARKS OF DR. GORDON MARKER, PRESIDENT, NATIONAL ALLIANCE FOR HYDROELECTRIC ENERGY, INC.

Mr. Chairman, my name is Gordon Marker and I am President of Essex Development Associates of Lawrence, Massachusetts. I am here today in my role as President of the National Alliance for Hydroelectric Energy. I am accompanied by NAHE general counsel James N. Broder.

NAHE is an alliance of people and businesses interested in developing the vast potential of hydropower for America. We have associated, initially, to speak for hydro's interests in Washington and to provide a bridge between Washington and the people who can develop this national resource.

NAHE was born out of a sense of a number of inequities, inequities that follow from the obvious legislative success that some more exotic and less cost effective technologies have had, both at the state and federal level. Now is the time, I think, to redress some of these inequities.

We sincerely appreciate the opportunity to appear before you today to express our views concerning S. 2766, the "Hydropower Development Act of 1980." This is the first opportunity that NAHE has had to participate formally in the legislative process. You can be sure that it will not be the last.

S. 2766, the "Hydropower Development Act of 1980", is designed to stimulate the development of hydropower projects. We strongly support this bill. With the appropriate encouragement, hydropower projects can make a substantial and immediate contribution to our national energy program. Moreover, hydropower offers significant advantages over other conventional alternative energy sources.

HYDROPOWER CAN MAKE A SIGNIFICANT CONTRIBUTION TO OUR NATIONAL ENERGY PROGRAM

Until recent times, hydropower was one of the principal sources of electric energy in the United States. In 1940, 40 percent of our electricity was generated by hydropower. Since then, the contribution of hydropower to the nation's electricity supply has declined to only 12.7 percent in 1978.

Studies by the Federal Energy Regulatory Commission (FERC) indicate that hydropower could play a much larger role, and that almost two-thirds of the nation's hydropower potential remains to be developed.

Furthermore, hydropower is a renewable resource that can be expected to contribute to our energy needs far into the future. This important factor sets hydropower apart from many other alternative energy sources. Even coal and oil shale are depletable resources that will not have a permanent impact on our energy needs. By contrast, hydropower will continue to supply energy long after conventional and unconventional fossil fuels have been completely exhausted. Yet this nation's energy policy discriminates against hydropower development.

HYDROPOWER IS ONE OF THE BEST AND MOST REALISTIC NEAR TERM ALTERNATIVE ENERGY SOURCES

With proper incentives, hydropower can increase its contribution to the nation's energy needs almost immediately. The basic hydropower technology has been used to generate electricity for nearly a hundred years, and recent technological improvements make it possible to generate electricity at small dams with low hydraulic heads. By contrast, the technology for exploiting many other alternative energy sources—such as ocean thermal energy—is still largely experimental, and even the most optimistic advocates of these energy sources acknowledge that they will not materially contribute to our energy needs for many years.

Because hydropower plants take less time to build, hydropower can also be expected to contribute to our energy needs sooner than many of the conventional alternative energy sources—such as coal—whose technology is proven. A hydropower generating project can be placed in service at an existing dam in from three to eight years. By comparison, a major coal power plant can take ten or more years to complete, and a nuclear power plant can take at least fifteen years to complete.

HYDROPOWER IS INFLATION-PROOF AND ECONOMICAL

One of the principal advantages of hydropower generating facilities is that their power source is free. The cost of fossile and nuclear fuel has risen dramatically during recent years, and will continue to increase in the future. By contrast, hydropower generating plants are virtually immune from inflation because the water that supplies the power does not have to be purchased. Of course, the repair costs of hydropower plants are subject to inflation just like repair costs at other plants. Nevertheless, the overall cost of hydropower is far less susceptible to inflation than the cost of other forms of power.

HYDROPOWER PROJECTS ARE ENVIRONMENTALLY SOUND

Hydropower projects are less destructive and disruptive to the environment than most other conventional and alternative energy production facilities. A hydropower project does not pollute the air or the water; its fuel does not have to be mined or refined. Finally, the extensive environmental reviews required during the licensing and permitting process guarantee that the environmental implications of a hydropower proposal will be carefully examined and balanced with other societal interests.

HYDROPOWER DEVELOPMENT WILL BENEFIT THE DOMESTIC ECONOMY

The continued use of imported oil and the resulting increase in the United States balance of payments deficit is doing serious damage to our economy. Hydropower development will help to undo some of this damage because most of the money spent on hydropower development will purchase goods and services from inside the United States. Moreover, once hydropower projects are in place, they will reduce the need to purchase expensive foreign oil. By reducing the flow of dollars out of the United States, hydropower development will help to strengthen the United States economy.

There are, however, those that argue that there is no need for tax incentives for hydropower development because of the high price of oil. The closeness in cost between a barrel of oil and a barrel's worth of hydropower does not mean that tax incentives for hydropower are not necessary. In the first place, it is inappropriate to compare the cost of oil with the cost of hydropower. The cost of oil is a currently deductible business expense, while the cost of developing a hydropower facility is a capital cost that can only be recovered through depreciation and credits over a period of years. Thus, the two figures are not really comparable.

Even if the cost of oil were comparable to the cost of hydropower, the government should encourage the use of hydropower over the use of oil because the real cost of a barrel of oil to the business consumer does not reflect the full social cost to the country of each incremental barrel of oil that is consumed. These social costs include the continued weakening of the dollars, slower economic growth, and international political tension. In Energy Future, the report of the Harvard Business School, it was estimated that the social cost of each incremental barrel of imported oil is 2.5 times the actual cost of imported oil (at a time when imported oil cost only $15 per barrel). By contrast, since hydropower development does not lead to an outflow of dollars (except to the extent that it is necessary to purchase imported equipment), the cost of hydropower does not include any hidden social costs. While the business customer may not consider the social costs of various energy alternatives in making its investments, the government should consider these costs in determining whether it is necessary to stimulate the development of alternative energy sources. Thus, even if the cost of oil and the cost of hydropower to the business customer are comparable, it is appropriate for the government to offer tax incentives for hydropower development.

It is also argued that hydropower will not really have an impact on oil and gas consumption. One of the uses for which hydropower is best suited is to provide power during periods of peak demand. Much of the electricity for peak periods is currently generated in gas turbines and in older, less efficient thermal plants which use oil and other fossil fuels. To the extent that it replaces other sources of peaking power, hydropower will have a significant impact on oil and gas consumption.

AN AGGRESSIVE PROGRAM OF INCENTIVES FOR HYDROPOWER DEVELOPMENT CAN MAKE A DIFFERENCE

The experience of other countries shows what a substantial impact an aggressive program of government incentives for hydropower development can have. In France, for example, low interest loans are available to hydro developers, and small hydro projects (sites under 8 MW) are guaranteed a market for their power. As a sult, hydropower accounts for 35 percent of France's electricity. On the Rhone iver alone, France has approximately 3,000 MW of installed capacity. By contrast, e Ohio River—whose characteristics are similar to those of the Rhone—has only 30 MW of installed capacity. An aggressive program of hydropower incentives ould provide similar benefits to the United States.

Given continuing price rises in imported oil, many more hydropower projects will ecome feasible—over time.

Given continuing price rises in foreign oil, more of the nation's hydropower esources will be developed—over time.

But how long must we wait?

Economic analysis of recently enacted incentives for hydropower development—rimarily through an 11 percent energy tax credit—indicate substantial and rapid ncremental new hydropower capacity on line in the near term.

This occurs because the tax credit reduces the effective capital cost of a hydroower project and pushes a certain additional number of hydropower projects above he feasibility level.

We believe that enactment of S. 2766 can have a similar impact on the development of hydropower capacity by reducing the capital cost (less capitalized interest) nd the debt service (reduced interest rate), thus creating incremental hydropower hat would not otherwise be developed in the near term.

We are not prepared today to present a detailed revenue loss projection estimate, or incremental power production estimates. We have neither the resources nor the nclination to engage in such studies. I say this because of the character of the ncentive proposal here.

We are not proposing a subsidy for not growing wheat. Nor are we proposing an entitlement or grant program. We are proposing that tax-exempt financing be available for a broad range of hydropower projects that will produce a clean, inflation-free, uninterruptible and domestic source of power.

Since the tax-exempt financing proposed hereunder is only available for the financing of a hydropower facility, any subsidy provided will be used only in aid of the direct purpose intended. Such targeting is an often desired but rarely achieved goal of public policy.

I would like to close with a plea to this committee for consistency and equity.

Our nation's energy policy must be consistent. We cannot afford policies that give on one hand and take away on the other. Our tax policy, often used to aid other national goals, should be consistent throughout. Our nation's energy policy must also be equitable. A brief review of the Crude Oil Windfall Profits Tax Act of 1980 will quickly reveal that hydropower is the stepchild of energy policy.

Ignored completely in the 1978 tax legislation, the incentives gained in the 1980 legislation leave hydropower roughly in the position of other alternative energy sources two years earlier. Perhaps some of the fault lay in the lap of the hydropower industry itself which did not strongly advocate its positions in 1978. However, the industry learned its lesson well.

The members of the private hydropower industry are the stewards of a proven technology that, with proper incentives, can make a significant contribution to this nation's energy security.

While a shiny new solar panel glints in the sun and commands the attention of policy-makers; while the exciting new technologies in new alternative energy sources capture our imaginations, and while we spend billions to harness the atom, power is washed out to sea as surely as our rivers continue to flow.

I believe that we can harness this power to the nation's benefit and that the proposed Hydropower Development Act of 1980 will assist in that effort.

STATEMENT OF SENATOR GRAVEL ON S. 2766

The development of hydroelectric power in the United States in recent years has been thwarted by the inability of many sponsors to finance hydroelectric facilities at reasonable rates. The initial cost of hydroelectric generating facilities is high. Because geography, geology, hydrology, and other site specific constraints required the construction of a particular size project initially, hydro projects often have excess capacity at the time of completion.

While in some cases this excess capacity can be sold to users elsewhere, it is often impossible to make full economic use of this capacity until the market served by the facility expands. This means that during the early years a hydroelectric facility may be more expensive to finance and operate than a smaller fossil fuel generating plan. However, in the long run the hydro facility is a much more economical way of generating electricity. Power rates in the Pacific Northwest bear living testimony to the long term low cost of generating electricity with hydroelectric facilities.

Prior to the Tax Act of 1968 there were minimal limitations on the use of tax exempt financing for hydroelectric facilities. Tax exempt bonds were issued to finance the construction costs of hydroelectric generating capacity keeping the costs within manageable limits. Changes adopted in the 1968 Tax Act brought all this to an end, severely limiting the situations in which tax exempt financing could be used.

These changes were adopted at a time when the United States was awash in cheap fuel. The public policy of limiting the use of tax exempt financing at that time outweighed the need for inexpensive alternative sources of electrical energy. Hydro projects throughout the United States were being abandoned in the pursuit of fossil fuel fired plants of lower initial costs.

However, the costs and uncertain supplies of fossil fuels have caught up with us. It is time to review the policy decisions made in the 1968 Tax Act with respect to tax exempt financing for hydroelectric facilities. We can no longer afford the luxury of a tax law which thwarts the development of this proven source of low cost renewable energy. Before discussing the Hydropower Development Act of 1980 let us take a few moments to consider the implications of existing law.

Interest on State and local government bonds is exempt from Federal income tax. This means that individuals are willing to accept a lower interest rate on these bonds saving the issuing States and local governments considerable amounts on their borrowing costs. If a State or local government bond is an "industrial development bond" the interest will be taxable with certain specific exceptions written into the Internal Revenue Code. Even though a bond is an industrial development bond, the interest may be tax exempt if the bond falls within the exceptions set forth in the Code.

WHAT IS AN INDUSTRIAL DEVELOPMENT BOND?

Bonds issued by a State or local government are industrial development bonds if:

First, a major portion of the proceeds of the bond issue are used in any trade or business not carried on by a State or local government or tax exempt organization, and

Second, payment of principal or interest is secured, in whole or major part, by an interest in, or derived from payment with respect to, property used in a trade or business.

The use of more than 25 percent of the proceeds of an issue of bonds in the trade or business of a nonexempt person will constitute the use of a major portion of the proceeds in a prohibited manner and will cause an issue to be treated as an industrial development bond. In the case of electric energy facilities, the use by one or more nonexempt persons of more than 25 percent of the output of the facility will cause an issue to be treated as an industrial development bond where the payments with respect to such use exceeds 25 percent of the total debt service on the issue.

This means that if more than 25 percent of the power from a hydroelectric project is to be sold to private users, including private power distribution companies distributing power to the general public, bonds sold by a municipality or State to finance construction of the facility will be industrial development bonds. In addition, if more than 25 percent of the power from a project is sold to the general public for use in a trade or business (that is, commercial users of power from a project constitute over 25 percent of the power demand) then bonds sold by a State or municipality to finance construction of the project will be industrial development bonds.

LOCAL FURNISHING OF ELECTRIC ENERGY

The Internal Revenue Code provides that interest on an industrial development bond may be tax exempt if the proceeds of the bond are used to provide "exempt activity facilities" among which are facilities for the "local furnishing of electric energy." This "local furnishing" test holds that a facility is for the local furnishing of electric energy (and interest on industrial development bonds to finance the facility is tax exempt) only if it is part of a system which provides electric energy to the general populace in a service area comprising no more than two contiguous counties, or a city and one contiguous county.

The effect of the local furnishing rule can be illustrated by an example. Provate Power Co. wants to build a 100 megawatt hydroelectric facility to serve its customers. The company goes to the city government and asks that the city issue industrial development bonds for the financing of the facility in order to lower the cost of project financing and the resultant power costs to consumers in the area.

The city agrees, securing the bonds with a lien on the project and its revenues. If the city is capable of consuming the entire 100 megawatts within its boundaries interest on the bonds will be tax exempt (assuming the public use test is met).

owever, if the city is located in more than two counties, or the facility has excess apacity which is sold into a grid, then even if the facility met all the other tests it ould fail the "local furnishing" test and therefore the interest on the bonds would e taxable.

PUBLIC USE

Even if a facility meets the "local furnishing" test interest on bonds used to inance construction may not be tax exempt unless the facility serves or is available n a regular basis for general public use. This test is satisfied only if the facility or he power output from it is available for use by members of the general public. "Use y members of the general public" does not refer to the ultimate user of the power, ut the first purchaser of the power or, in the case of a privately owned utility, the istributor of the power.

Thus, if a project sells any significant portion of its power to a private power ompany for distribution to members of the general public, or if a private power ompany owns a generating facility the power from which is sold to the general ublic, tax exempt financing is precluded. However, if power from the same project s sold to a publicly owned utility for distribution, or if the project is owned by a municipal or State company, tax exempt financing would be allowed under the "public use" test.

The distinctions drawn by the public use test between private and publicly owned distribution and generating systems does not serve Federal tax and energy policy well. This test discriminates in the cost of financing for hydroelectric projects based on accidents of history in the development of power systems serving communities throughout America. In some places municipal systems for generation and distribution are owned by the cities, counties or other governmental bodies. In other parts of the country power generation and distribution systems developed as privately owned systems providing power at a profit to members of the community. Under a "public use" test the former communities are entitled to finance their power supplies through the use of tax exempt bonds, but the latter communities are precluded from this low cost alternative.

Real world examples of the inequities imposed by this rule abound. The city of Los Angeles is served by the Nation's largest municipally owned public utility, the Los Angeles Department of Water and Power. The department has 1.2 million customers and 1978 sales of almost 18 billion kilowatt hours. The entire generating capacity of the department, nearly 2,000 megawatts of hydro and pump storage, were constructed through the use of tax exempt financing.

By contrast Northwestern Wisconsin Electric Co. is privately owned and provides power to 10,000 customers. This company has total capacity of 15 megawatts with 2.3 megawatts of hydroelectric generating capacity. It had 1978 sales of approximately 82 kilowatt hours. Until passage of the 1980 amendments to Internal Revenue Code section 103 in the Crude Oil Windfall Profit Tax Act of 1980, Northwestern Wisconsin Electric Co. was denied access to tax exempt financing for any expansion of its hydro capacity.

Even with the changes in the Windfall Profit Tax Act investor owned public utilities may not finance hydro facilities over 100 megawatts with tax exempt bonds while publicly owned utilities, such as the Los Angeles Department of Water and Power can continue to do so.

Mr. President, in order to correct the inequities in Internal Revenue Code section 103 with respect to the development of America's undeveloped hydroelectric resources I am introducing the Hydropower Development Act of 1980. This legislation permits the use of tax-exempt financing for any project the primary purpose of which is the generation of hydroelectric power. This change in section 103 eliminates the "public use" test and the "two county" rule.

It will place all developers of hydropower on the same footing with respect to the cost of power from similar new hydroelectric development. This change in the law will apply to all hydroelectric development regardless of size.

I am pleased to say that an amendment similar to the one included in this bill was included by the Senate Finance Committee in the windfall profit bill and was approved by the Senate in acting on that legislation. Unfortunately, the measure was deleted in conference at the insistence of the House conferees and a scaled-back provision dealing solely with small facilities was substituted.

HYDRO: THE BEST CONVENTIONAL POWER SOURCE

Hydroelectric generation of power is the cheapest, cleanest, and most environmentally sound of the conventional alternatives. The generation of electricity through the use of hydro is much less damaging to the environment than burning coal or oil.

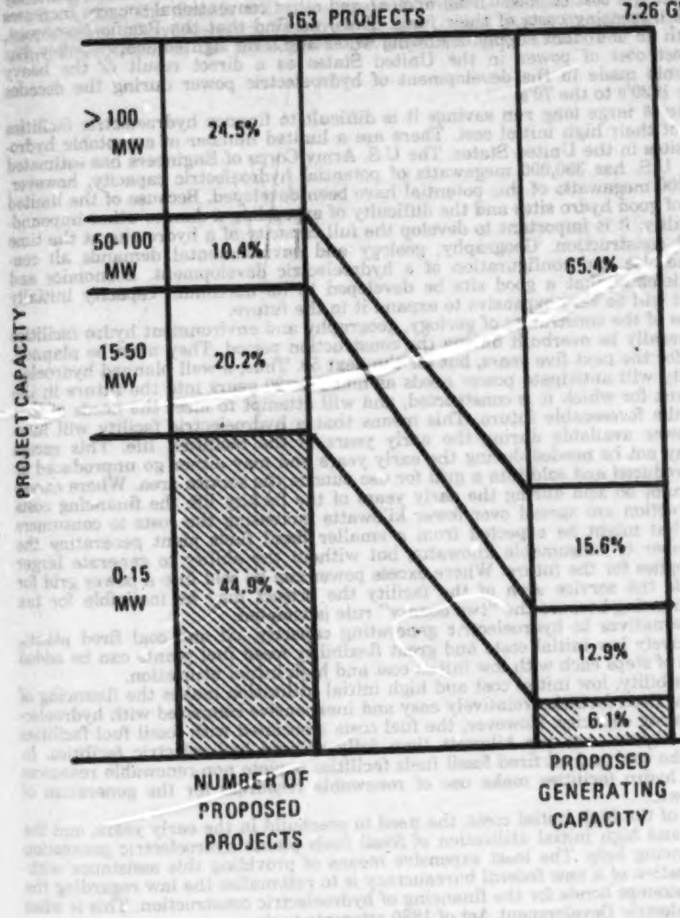
It does not pollute the air nor require the continued depletion of natural resources, and water pollution can be minimized.

Hydroelectric generating facilities offer proven technology which works efficiently and effectively today. It is not a technology in the experimental stage with massive additional development required to make it economic at today's fossil fuel prices. Hydroelectric facilities have been constructed in this country since before the turn of the century and development of the technology to take advantage of this vast resource has already taken place.

Hydro power is inexpensive over the long run. Since hydro draws on the renewable resource of flowing water to turn its generators no fuel costs are involved. During the oil rich days of the 1950's and 60's it was cheaper, even after fuel costs, to generate electric power through the use of fossil fuel fired plants. However, the days of cheap fossil fuels are gone, and now, despite high initial costs for hydro facilities, the cost of power over the life of a hydro project is lower than the cost of power from fossil fuel plants. Because of the low cost of fossil fuels we have neglected the remaining hydroelectric potential of the United States. With the current shortage in world energy supplies it is time to move aggressively to develop this potential.

Some people feel that while hydroelectric generation is an excellent means of assisting in the energy crises we should look first to "small hydro" rather than encouraging hydro generally. It is suggested that small hydro, 25 megawatts or less, is somehow preferable to larger facilities. But, while small hydro development is healthy, the real gains in hydro generating capacity come from projects over 50 megawatts. This fact is aptly illustrated by the following chart:

Currently Proposed Hydroelectric Projects
(not including pumped storage)



SOURCE: FERC LISTINGS - JUNE 30, 1979.

HYDRO NEEDS FINANCING HELP

The development of hydroelectric generating capacity is very expensive. However, over time hydroelectric generation of electricity has proven to be the cheapest of our conventional sources. This low cost is a result of the renewable resource upon which hydroelectric facilities operate, flowing water. The renewable nature of this power source means that the cost of power from hydro facilities remains relatively fixed while the cost of power from nuclear and other conventional sources increases with the increasing costs of their fuels. Thus, we find that the Pacific Northwest, blest with an abundant supply of flowing water and a far sighted energy policy, has the lowest cost of power in the United States as a direct result of the heavy investments made in the development of hydroelectric power during the decades from the 1930's to the 70's.

In spite of large long run savings it is difficult to finance hydroelectric facilities because of their high initial cost. There are a limited number of acceptable hydroelectric sites in the United States. The U.S. Army Corps of Engineers has estimated that the U.S. has 390,000 megawatts of potential hydroelectric capacity, however, only 57,000 megawatts of this potential have been developed. Because of the limited number of good hydro sites and the difficulty of expanding a dam or other impoundment facility, it is important to develop the full capacity of a hydro site at the time of initial construction. Geography, geology and environmental demands all constrain the size and configuration of a hydroelectric development. Economics and geology demand that a good site be developed to its maximum capacity initially because it will be very expensive to expand it in the future.

Because of the constraints of geology, geography and environment hydro facilities must generally be overbuilt during the construction period. They must be planned, not only for the next five years, but for the next 50. Thus, a well planned hydroelectric facility will anticipate power needs as much as 20 years into the future in the service area for which it is constructed, and will attempt to meet the needs of that area for the foreseeable future. This means that a hydroelectric facility will have excess power available during the early years of the facilities' life. This excess power may not be needed during the early years and may either go unproduced or may be produced and sold into a grid for use outside the service area. Where excess power cannot be sold during the early years of the facility life the financing costs for construction are spread over fewer kilowatts increasing the costs to consumers beyond what might be expected from a smaller fossil fuels plant generating the same number of consumable kilowatts, but without the ability to generate larger power supplies for the future. Where excess power can be sold into a power grid for use outside the service area of the facility the project may be ineligible for tax exempt financing because the "two county" rule is violated.

The alternatives to hydroelectric generating capacity, oil and coal fired plants, have relatively low initial costs and great flexibility fossil fuel plants can be added in a series of steps each with low initial cost and high initial utilization.

This flexibility, low initial cost and high initial utilization makes the financing of oil and coal fired facilities relatively easy and inexpensive compared with hydroelectric generating capacity. However, the fuel costs associated with fossil fuel facilities results in higher costs per kilowatt than fully utilized hydroelectric facilities. In addition, the coal and oil fired fossil fuels facilities deplete non-renewable resources while the hydro facilities make use of renewable resources for the generation of electric power.

Because of the high initial costs, the need to overbuild in the early years, and the flexibility and high initial utilization of fossil fuels plants hydroelectric generation needs financing help. The least expensive means of providing this assistance without the creation of a new federal bureaucracy is to rationalize the law regarding the use of tax exempt bonds for the financing of hydroelectric construction. This is what the Hydroelectric Development Act of 1980 attempts to do.

THE ALTERNATIVE: FEDERAL CONSTRUCTION

The alternative to federal encouragement of hydroelectric construction through rationalization of the tax rules is full federal funding of hydro projects. In the past the federal government has spent billions for the construction of major hydroelectric facilities. Federal dams on the Columbia River alone have cost over $2.5 billion. These dams generate over 4,500 megawatts of electricity and have assured the Pacific Northwest the lowest power costs in the United States.

Most large hydroelectric projects constructed to date have been federally financed and built. However, the Congress has in recent years been seeking ways in which State and local involvement in the construction of public works projects can be increased in order to ease the burden on the federal government. The Hydropower

Development Act of 1980 can reduce the obligations of the federal government with respect to the development of our hydroelectric resources by making it easier for these facilities to be financed through State, local and private sources. America's remaining hydroelectric potential can no longer be ignored. In light of the energy crises we must develop this important resource and the Hydropower Development Act will help ensure that the burden of this development is not born solely by the federal government.

I hope that the Senate will once again express its concern for the expeditious development of hydroelectric resources in the United States by taking speedy and affirmative action on the Hydropower Development Act of 1980.

BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Hydropower — An Energy Source Whose Time Has Come Again

EXCERPTED

Recent price increases in imported oil demonstrate the urgency for the U.S. to rapidly develop its renewable resources. One such renewable resource for which technology is available now is hydropower.

Studies indicate that hydropower potential, particularly at existing dam sites, can save the country hundreds of thousands of barrels of oil per day. But problems and constraints--economic, environmental, institutional, and operational--limit its full potential.

Federal programs have had little impact on helping to bring hydro projects on line. Specifically, the Department of Energy's Small Hydro Program could do more to overcome hydro constraints and problems through an effective outreach program and more emphasis on demonstration projects.

UNITED STATES GENERAL ACCOUNTING OFFICE

EMD-80-30
JANUARY 11, 1980

CHAPTER 2

BACKGROUND AND PERSPECTIVE

WHAT IS HYDRO?

Hydropower, in its simplest form, is the production of energy produced from water flowing through a turbine which spins a generator. Conventional hydroelectric systems use dams and waterways to harness the energy of falling water (See figure 2.1.) These include reservoirs or storage systems at dams and run-of-river type operations which cause minimal fluctuations of streamflows. Pumped storage systems (see figure 2.2) use the same principle of falling water for the generating phase, but all or part of the water is made available for repeated use by pumping it from a lower to an upper reservoir.

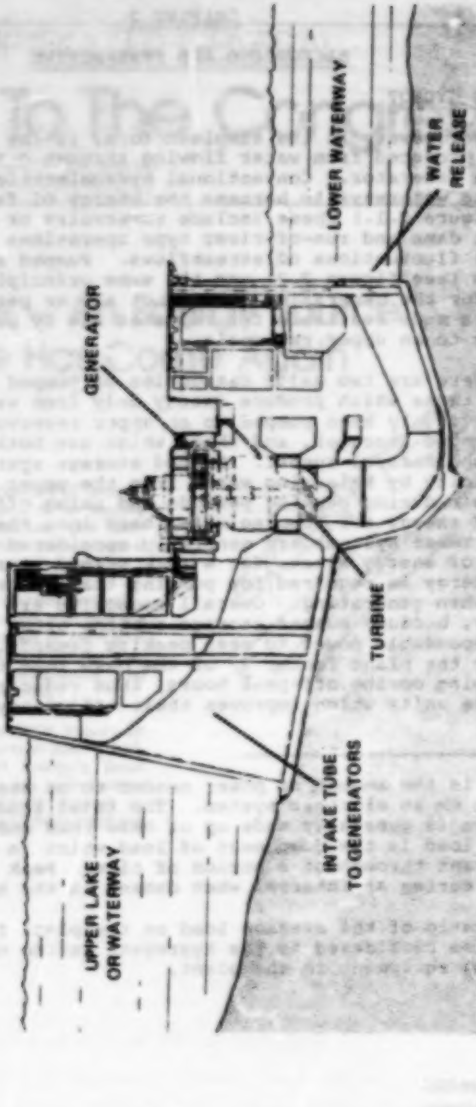
There are two major categories of pumped storage systems: those which produce energy only from water that has previously been pumped to an upper reservoir (known as pure pumped storage), and those which use both pumped water and natural runoff. Pumped storage systems generate electricity by releasing water from the upper to the lower reservoir during peaking periods and using off-peak base load 1/ energy for pumping water back into the upper reservoir. These systems are generally considered to be net consumers of energy since, for a pure pumped storage project, more energy is required for pumping than is produced by the plant when generating. Overall economics are favorable, however, because pumped storage systems often provide the most dependable power to meet peaking demands. They also improve the plant factor 2/ of the base load thermal units by pumping during off-peak hours, thus reducing cycling of these units which improves their efficiency and durability.

1/Load is the amount of power needed to be used at a given point on an electric system. The total load of a utility system is generally made up of base load and peak load. Base load is the component of load which is more or less constant throughout a period of time. Peak load is the load during an interval when demand is the highest.

2/The ratio of the average load on the plant for the period of time considered to the aggregate rating of all the generating equipment in the plant.

FIGURE 2.1

CONVENTIONAL HYDROELECTRIC SYSTEM


UPPER LAKE
OR WATERWAY
INTAKE TUBE
TO GENERATORS
TURBINE
GENERATOR
LOWER WATERWAY
WATER
RELEASE

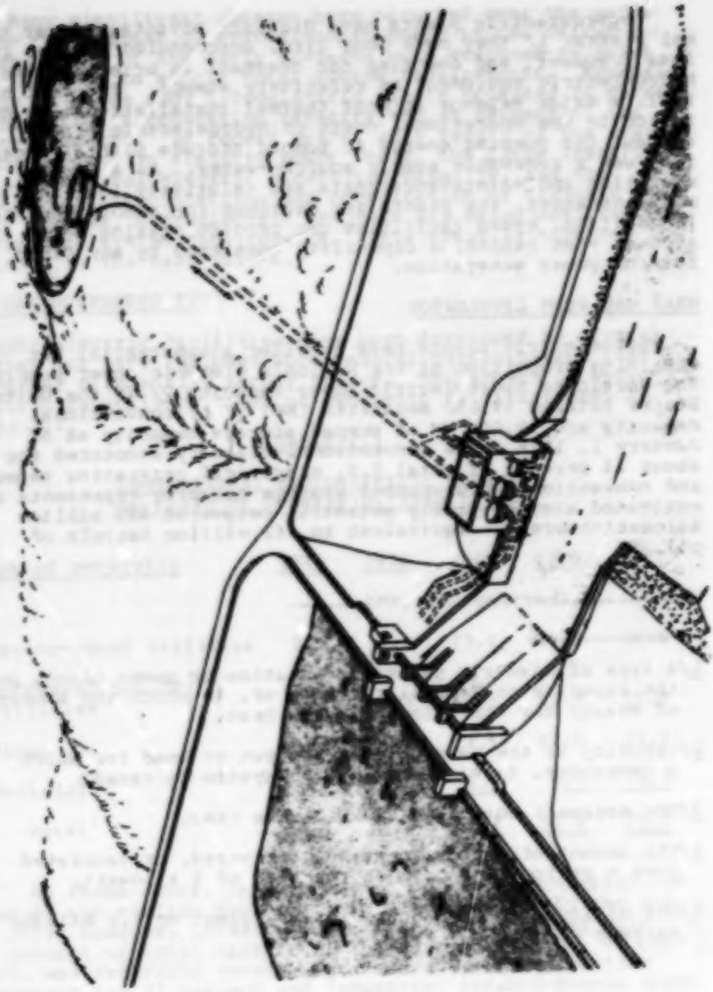


FIGURE 2.2
PUMPED STORAGE SYSTEM

Hydroelectric plants have distinct advantages over thermal plants: 1/ they have long life, unscheduled outages are less frequent, and downtime for overhaul is brief because hydroelectric equipment is relatively simple. The cost of fuel, a major expense in most thermal installations, is not a factor in the operational costs of hydroelectric plants (except for pumping energy at pumped storage plants) because they use a renewable supply source--water. As a result, operation and maintenance costs are relatively low, and in many instances, the plants are designed for remote control. In addition, hydro facilities can provide peaking power in seconds when needed, a capability unmatched by any other form of power generation.

WHAT HAS BEEN DEVELOPED?

Hydroelectric plants have provided a substantial but declining proportion of the Nation's electric power supply. The developed hydroelectric power capacity 2/ in the United States totaled 59,000 megawatts (MW) 3/ of conventional capacity and 10,000 MW of pumped storage capacity as of January 1, 1978. The conventional capacity accounted for about 11 percent of total U.S. electrical generating capacity and conventional plus pumped storage capacity represents an estimated average yearly potential output of 289 billion kilowatt-hours 4/--equivalent to 462 million barrels of oil. 5/

1/A type of electric generating station or power plant, or the capacity or capability there of, in which the source of energy for the prime mover is heat.

2/Capacity is the maximum power output or load for which a generator, turbine station, or system is rated.

3/One megawatt equals 1,000 kilowatts (kW).

4/The amount of energy consumed, delivered, or generated over a period of 1 hour at the rate of 1 kilowatt.

5/One billion kilowatt-hours is equivalent to 1.6 million barrels of oil.

Many significant changes have occurred over the years in the development of hydroelectric power in the United States. Most of the early projects were designed to serve base loads or to supply total system requirements. Approximately 40 years ago, hydroelectric plants provided 30 percent of the Nation's generating capacity and 40 percent of the electric energy. In recent years, as a result of the tremendous growth in electric power loads, the large installations of thermal electric generating capacity, and the increasing interconnection and coordination of electric power systems, hydroelectric projects are being designed to supply peak system requirements. This trend is expected to continue in the near future.

WHO HAS DEVELOPED IT?

Hydroelectric facilities have been developed by several parties but have included more Federal participation than any other electricity supply source. The growth in hydroelectric capacity by class of ownership is illustrated in table 2.1.

TABLE 2.1

Conventional Hydroelectric Capacity by Class of Ownership, 1940 to 1977

Class of ownership	1940	1950	1960	1970	1977
	(MW, 000 omitted)				
Investor-owned utilities	8.5	9.7	13.4	16.3	16.5
Non-Federal public utilities	1.1	1.5	4.4	11.9	12.8
Federal	1.7	6.5	14.6	23.0	29.2
Industrial	1.1	1.0	0.7	0.7	0.7
Total	12.4	18.7	33.1	51.9	59.2

As shown above, investor-owned utilities accounted for most of the earlier hydroelectric development. By the end of 1977, however, investor-owned capacity comprised only 28 percent of total capacity. The largest portion, 49 percent, was federally owned. Non-Federal public utilities accounted for 22 percent and industrial establishments about 1 percent.

The total installed hydroelectric capacity operated by Federal agencies at the end of 1977 is given in table 2.2.

TABLE 2.2

Total Federal Hydroelectric Capacity

Federal Agency	Installed Capacity (MW)
Corps of Engineers	16,500
Bureau of Reclamation	9,352
Tennessee Valley Authority	3,256
Alaska Power Administration	77
International Boundary and Water Commission	31
Bureau of Indian Affairs	14
National Park Service	3
Total	29,233

The Federal presence in hydroelectric development reflects a broad range of objectives and has occurred largely as an indirect result of achieving other goals. The U.S. Army Corps of Engineers and the Department of the Interior's Bureau of Reclamation, which have developed most of the Federal hydropower, have primary goals of constructing water resources projects for flood control, navigation, and irrigation. Power production has usually been considered a secondary benefit or purpose of the water resource projects. The Tennessee Valley Authority, on the other hand, was not only authorized to regulate the streamflow of the Tennessee River "primarily for the purposes of promoting navigation and controlling floods," but also,

> "so far as may be consistent with such purposes* * * whenever an opportunity is afforded to provide and operate facilities for the generation of electric energy, in order to avoid the waste of water power* * *." (16 U.S.C. 831 h-1)

Non-Federal development of hydropower facilities has had one main objective--to obtain a generating source of electricity. Before a non-Federal water power project can be built in most cases, a license must be obtained from the

Department of Energy's Federal Energy Regulatory Commission (FERC). 1/ The licenses are issued for a period up to 50 years and require that any hydroelectric project be adapted to a comprehensive plan for the development and use of water resources for multi-beneficial purposes, including recreation. FERC had issued 655 licenses as of January 1, 1978.

WHAT IS BEING DEVELOPED?

Although hydroelectric power now accounts for about 13 percent of the total U.S. generating capacity, that proportion is expected to decline to less than 10 percent by 1990. This trend is expected despite the construction of many large pumped storage plants, which will comprise about 70 percent of the planned capacity added through 1990. Currently, 7,200 MW of conventional hydroelectric capacity is being constructed. Of this, 5,600 MW is being constructed by the Federal water agencies and 1,600 MW by non-Federal entities. Another 4,200 MW of capacity has been authorized for future Federal construction. In addition, 26,600 MW of capacity from pumped storage was under construction, authorized, or included in the licensing approval process as of January 1, 1978.

A January 1978 FERC inventory of hydroelectric potential with sites over 5 MW estimated remaining capacity at about 110,000 MW. This figure will increase, however, because of recent interest in the development of smaller projects. Rising fuel and construction costs of thermal powerplants and the need to develop renewable energy resources have given emphasis to reevaluation of projects which were considered marginal or uneconomical a few years ago. The following chapter discusses the reasons for renewed optimism in hydropower and the status of studies on hydro potential.

1/Previously the Federal Power Commission.

CHAPTER 3

HYDRO POTENTIAL

Hydroelectricity, as a percentage of total electricity, has been declining for several years. Many plants having relatively small capacities have been retired because they were not economical when compared to fossil fuel plants. This trend is beginning to change, however, because of increased fossil fuel costs. Some electricity planners now see hydroelectric generation as a possible economical option to fossil fuel plants. This raises the question of just how much hydro potential the United States has and how much of it can be developed.

FOREIGN EXPERIENCE

If the experience of several European countries in hydro development is an example of what can be developed, indications are that the United States has more hydro potential than once believed.

An example of aggressive hydro development has been demonstrated in France. Hydropower on the average accounts for 35 percent of France's electrical generating capacity. More important, however, is its approach to getting the hydro developed and the makeup of the hydro system. France has a national policy that anyone who develops a hydro project of under 8 MW capacity will be guaranteed a market for that power, regardless of the cost. Also, under sponsorship of the French Government, low-interest bank loans are made available to hydro developers, with the Government providing the difference in the interest rates. The rationale behind such policies is to develop maximum potential of domestic energy and renewable resources so there is less dependence on energy imports. The result has been a country with one of the most intensively developed hydro systems which includes many small projects and a significant small-hydro technology and manufacturing base.

The United States, in comparison, has developed a part of its water resources system, but small-hydro projects in recent years have not been pursued. In fact, older small projects have been shut down as the equipment has worn out. The result is that the United States has about 49,000 identified dams, but only 1,400, or 3 percent of them, produce electricity. Also, only one major U.S. turbine manufacturer is still in the small-hydro business.

An example of the contrasting approaches of France and the United States is to compare two rivers with similar characteristics--the Rhone and the Ohio. The Rhone, which has been developed extensively, has a capacity of about 3,000 MW, while the capacity of the Ohio is about 180 MW. This means that the Rhone has over 16 times more hydroelectric generation potential than the Ohio.

A major reason for French and other European interest in hydro is purely economic. Hydro has been seen as a method to reduce expensive fossil fuel imports.

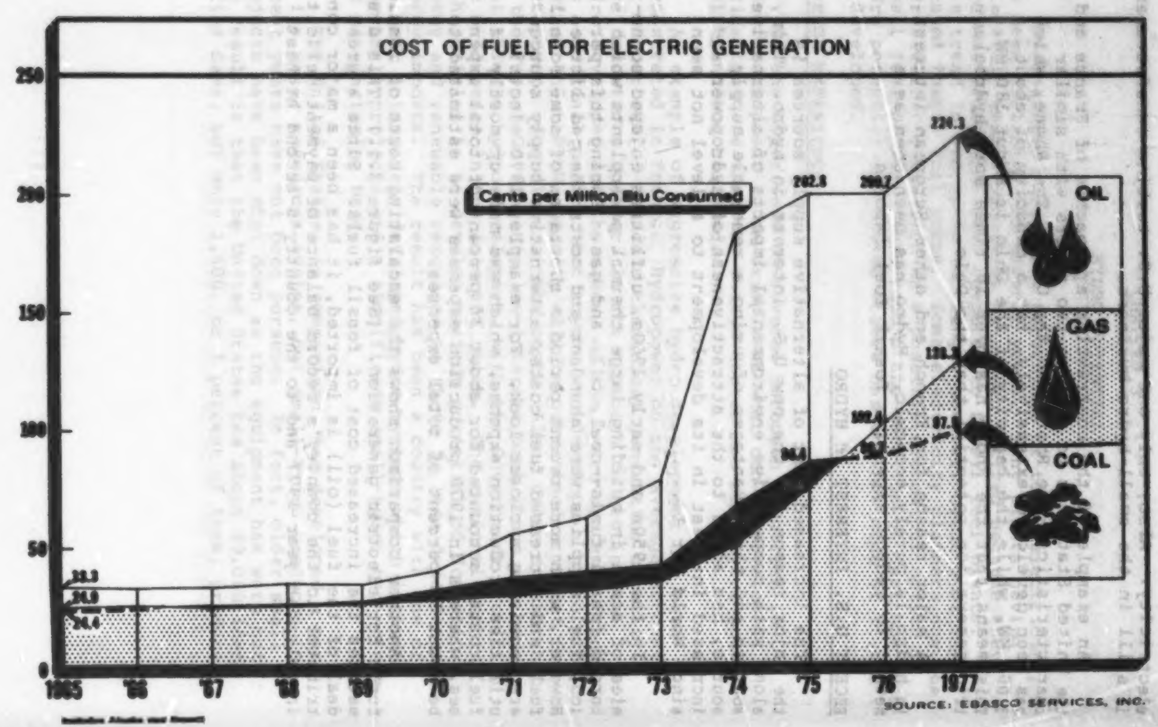
RECENT U.S. INTEREST IN HYDRO

The increased cost of alternative supply sources is the major reason for the new U.S. interest in hydro. This, along with comparative environmental impacts of alternative sources and the advantages of using a renewable supply source, has added to the attractiveness of hydropower and increased interest in its development to a level not seen since World War II.

In the 1950s and early 1960s, utilities enjoyed economies of scale in building large thermal powerplants which burned fossil fuels--coal, oil, and gas. During this period, fuel supplies were abundant and costs changed little. However, with more recent periodic shortages of some fossil fuels and increased fuel costs, alternative supply sources are receiving a closer look. For example, 1970 electric utilities production expense, which was made up mostly of fuel costs, accounted for about 36 percent of total expenses, whereas in 1978 production expenses were estimated to be about 58 percent of total expenses.

Another comparison shows the escalating costs of fossil fuels for electric generation. (See figure 3.1.) This dramatizes the increased cost of fossil fuels. Since a great deal of the fuel (oil) is imported, it has been a major contributor to the country's record balance of payment deficit in calendar year 1977 and to the country's second highest

FIGURE 3.1



SOURCE: EBASCO SERVICES, INC.

TABLE 3.1

Studies to Assess Hydro Potential and Source of Funds for the Studies

Organization doing study	Funds being provided by	Fiscal year expenditures 1978	1979	1980	1981
			(000 omitted)		
New England River Basins Commission	WRC	$ 325	$ 425	$ 225	-
Bureau of Reclamation	Congress	-	a/ 400	-	-
Corps of Engineers	DOE	250	200	-	-
Corps of Engineers	Congress	1,000	2,250	3,000	$ 750
Bureau of Reclamation	Congress	-	420	420	120
Corps of Engineers (note b)	Congress	5,000	5,000	-	-

a/Eighteen site specific hydro facilities.

b/Authorized in section 167 (d) of the Water Resources Development Act of 1976 but not funded at this time.

balance of payment deficit in calendar year 1978. 1/ With the economic climate for the resurgence of small-scale hydro installations, Federal and utility planners are focusing more attention on hydropower.

Another reason for interest in retrofitting small existing dams is that few environmental barriers exist. The dam structure is in place and retrofitting or adding a power house would appear to have few unfavorable impacts on biological production and diversity.

Various other factors have contributed to the renewed interest in small-hydro plants. Municipalities and small public utilities, which have traditionally been dependent on large privately-owned utilities for power supplies, visualize development of small local dams as a means of becoming more independent. For this reason, the greatest interest in small dams has been shown by publicly owned utilities, municipalities, cooperatives, and irrigation districts.

HYDRO STUDIES

With renewed interest in hydropower comes increased optimism that the United States has more potential power than previously believed. This has led to studies, some of which have been completed, to assess the total U.S. hydro potential. Most of the studies have been or are being conducted or funded by different Federal agencies (see table 3.1). Those studies which have been completed offer optimism for hydro potential.

Corps of Engineers

The Corps of Engineers has completed one study on hydro potential from existing dams and is identifying total U.S. potential in another. The completed study was requested by the President in announcing the National Energy Plan; the study in process was requested by the Congress.

The President, in introducing the National Energy Plan, pointed out the potential for developing power at small-hydro

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1/1978's balance of payments deficit was mitigated due to Alaskan crude oil coming on line.

projects and requested that the Corps do a 90-day assessment at existing dams. The Corps' assessment was announced in a July 20, 1977, report 1/ to the President. It identified total potential of 54,600 MW of capacity from existing facilities. Specific development would include:

--5,100 MW of additional capacity by installing more efficient turbines and more powerful generators at existing dams; 2/

--15,900 MW of capacity by installing additional turbines and generators to existing dams; and

--33,600 MW by constructing power houses at existing non-hydro power dams.

The report further pointed out that, if developed, this potential capacity could save 727,000 barrels of oil per day, but it indicated that constraints could stand in the path of some development. It recommended that emphasis be placed on small-hydro demonstrations to measure the severity of any constraints. A recent Corps assessment of this study indicates that potential will be somewhat less than previously identified.

The Corps' study of total hydro potential which is currently in process was authorized by the Congress through passage of Public Law 94-587 in 1976. The Corps estimated that this effort would take 3 years and started the assessment (referred to as the National Hydropower Study) in the summer of 1978. The assessment, which will cost about $7 million, is being conducted by the Corps' Institute for Water Resources and should be concluded by September 1981.

The study primarily will assess (1) the physical potential for hydroelectric development and how certain factors--economic, social, environmental, and institutional--will affect the realization of hydropower's physical potential and (2) the regional distribution of hydropower potential and its

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1/"Estimate of National Hydroelectric Power Potential at Existing Dams."

2/A similar recommendation is in our report, "Power Production At Federal Dams Could Be Increased By Modernizing Turbines And Generators," EMD-77-22, Mar. 16, 1977.

maximum integration with other types of generating facilities in order to meet electricity needs. This study will be the most comprehensive hydro assessment performed in the United States. The assessment will include all hydro potential, regardless of size.

Bureau of Reclamation

The Department of the Interior's Bureau of Reclamation, which operates hydroelectric projects in 15 western States completed a study 1/ in February 1977 on hydroelectric potential in its service area. The study concluded that 34 specific sites representing a potential installed capacity of 11,300 MW were appropriate for further study. Dams are already constructed at some of these sites, and by uprating these existing units and adding units, these dams would provide more capacity. Sixteen of the potential sites would have 460 MW of capacity and could produce energy at plant factors equivalent to base load facilities. These plants could generate 2,290 billion kWh of energy, thus saving an equivalent of about 1.1 million tons of coal annually in base load energy. Another 11 potential sites would provide intermediate and peaking power with an 800-MW capacity, which could generate 600 billion kWh of energy and save 1 million barrels of oil annually.

The remaining seven sites are pump storage facilities with 10,040 MW of capacity capable of generating 16,400 billion kWh of peaking power annually, which could save 28.5 million barrels of oil each year. The pumping would require an equivalent of 11.5 million tons of coal annually in base load energy. These potential developments would, therefore, shift fuel consumption from limited supplies of oil and natural gas for peaking power to the more abundant coal resource for base load power.

In addition, the Bureau is conducting a three year study of hydropower potential in the seventeen western States. This study will assess areas never seriously considered previously such as potential derived from drops in irrigation canals and conduits.

1/"Western Energy Expansion Study."

CHAPTER 5

CONSTRAINTS AND PROBLEMS LIMITING HYDRO DEVELOPMENT

Hydroelectric Financing

The U.S. Treasury and the Internal Revenue Service set rules that affect the taxability of bonds. IRS regulation 1.103.7 states that if more that 25 percent of the electricity generated at a power project is sold to a private utility or transmitted over private utility lines, then the bonds sold by a public utility are subject to Federal income tax. Under this rule the public utility must pay 2 to 3 percent more in interest to attract investors. The added costs could increase the interest costs by 50 percent over the project's life. For example, the Nevada Irrigation District started the $8 million (13 MW) Rollins small hydro project expecting to sell Federal tax exempt bonds at around 6 1/2 percent interest. 1/ Instead the Irrigation District had its bond declared taxable by IRS because the District sold the power to a private utility. The market rate for the taxable bonds was 9-7/8 percent.

This situation indicates how State and Federal tax policies can seriously inhibit hydroelectric development. Public non-profit agencies, such as irrigation districts, want to develop hydroelectric resources as a means of reducing the cost of their principal activity, selling irrigation water. But revenues from a successful hydro project could subject them to State and Federal regulation and taxation as an electric utility.

The House of Representatives passed legislation to expand the use of tax-exempt bonds to include certain private hydroelectric energy facilities. Presently the bill is awaiting passage by the Senate.

The Department of the Treasury does not support this because the agency feels the extension will put additional burdens on the tax-exempt market and drive up the cost of conventional municipal financing. The Treasury went on to say that the legislation would result in an increased level of subsidy of conventional municipal borrowing as a consequence of generally higher interest rates in the tax-exempt market.

1/It should be noted that a non-taxable status is a subsidy from the general public to serve a designated, specific social purpose.

SUBMISSION TO
THE SENATE COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT

HYDROPOWER DEVELOPMENT ACT OF 1980/S. 2766
IMPLICATIONS OF EXTENDING TAX-EXEMPT FINANCING TO PRIVATE DEVELOPERS OF HYDROELECTRIC PROJECTS

JULY 3, 1980

BOOZ • ALLEN & HAMILTON INC. HAS BEEN ASKED TO ESTIMATE THE TAX REVENUE IMPACT IF TAX-EXEMPT FINANCING OF LARGE HYDROELECTRIC PROJECTS (EXCEEDING 100 MW) IS EXTENDED TO PRIVATE DEVELOPERS[1]. IN RESPONSE, WE HAVE PREPARED THIS DOCUMENT WHICH DISCUSSES:

- CURRENT SITUATION
  - EXISTING AND PROPOSED TAX LAWS
  - OUR NATION'S HYDROELECTRIC POTENTIAL
- ESTIMATED IMPACT OF EXTENDING TAX-EXEMPT FINANCING TO:
  - PROPOSED PROJECTS EXCEEDING 100MW
  - POTENTIAL (BUT UNPLANNED) PROJECTS
- SUMMARY OF FINDINGS

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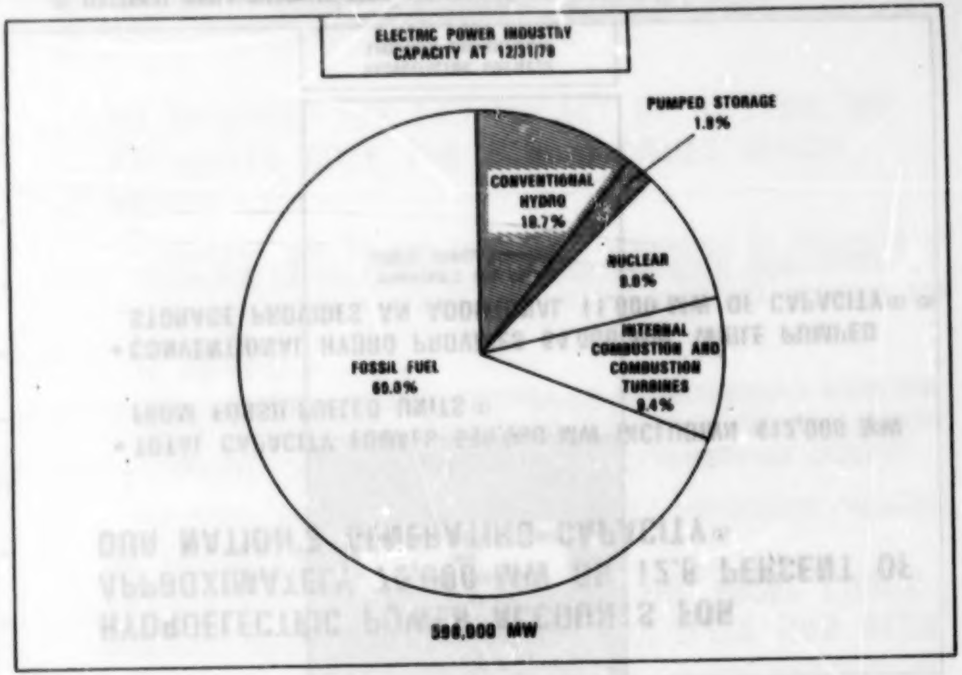
(1) INVESTOR-OWNED UTILITIES AND PRIVATE INDUSTRY

I. CURRENT SITUATION

TAX LAWS CONCERNING TAX-EXEMPT FINANCING OF HYDROELECTRIC PROJECTS HAVE BEEN MODIFIED:

- IN THE PAST, PRIVATE DEVELOPERS HAVE NOT BEEN ABLE TO FINANCE HYDROELECTRIC PROJECTS THROUGH THE ISSUANCE OF TAX-EXEMPT BONDS
- TO SPUR THE FURTHER DEVELOPMENT OF HYDROELECTRIC POWER, SECTION 103 OF THE INTERNAL REVENUE CODE WAS RECENTLY AMENDED BY THE WINDFALL PROFIT TAX ACT TO PERMIT TAX-EXEMPT FINANCING OF SMALL (LESS THAN 100 MW) PRIVATELY-OWNED HYDRO FACILITIES
- PROPOSED S. 2766 WOULD EXTEND THE BENEFIT OF TAX-EXEMPT FINANCING TO ALL HYDROELECTRIC DEVELOPMENT REGARDLESS OF PROJECT SIZE AND OWNERSHIP

HYDRO ACCOUNTS FOR APPROXIMATELY 76,000 MW OR 12.6% OF THE ELECTRIC POWER INDUSTRY'S CAPACITY



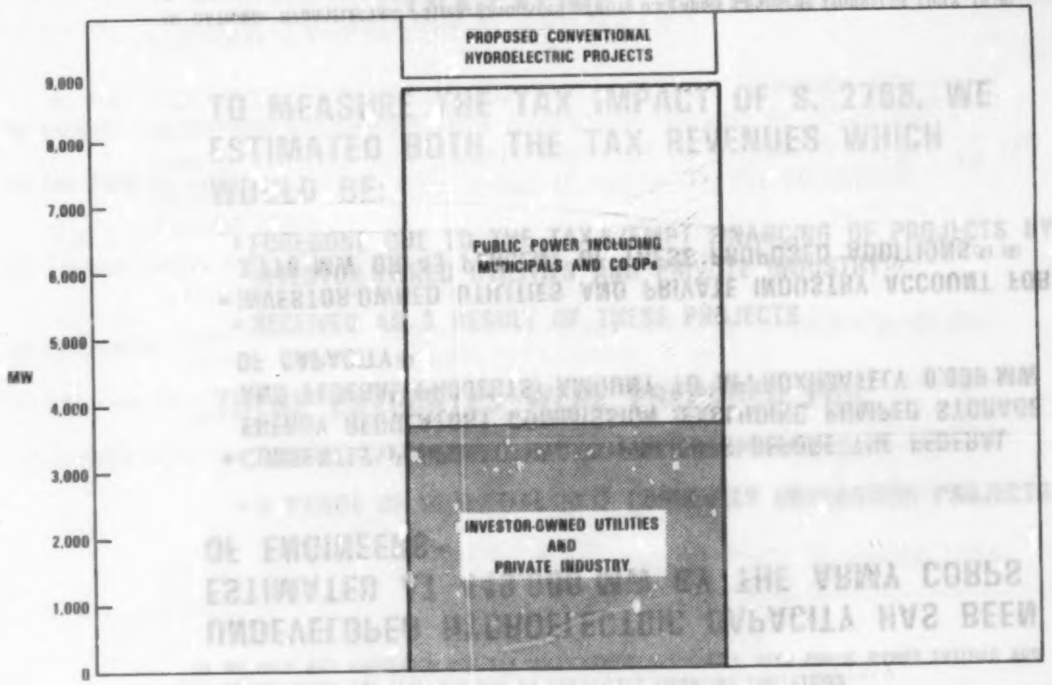
CURRENT SITUATION . . .

HYDROELECTRIC POWER ACCOUNTS FOR APPROXIMATELY 75,000 MW OR 12.6 PERCENT OF OUR NATION'S GENERATING CAPACITY (2)

- TOTAL CAPACITY EQUALS 598,000 MW INCLUDING 412,000 MW FROM FOSSIL-FUELED UNITS (2)
- CONVENTIONAL HYDRO PROVIDES 64,000 MW, WHILE PUMPED STORAGE PROVIDES AN ADDITIONAL 11,000 MW OF CAPACITY (2) (3)

(2) ELECTRICAL WORLD (MARCH 15, 1980)
(3) 1979 ANNUAL ELECTRIC POWER SURVEY

INVESTOR-OWNED UTILITIES AND PRIVATE INDUSTRY ACCOUNT FOR 43% OF PROPOSED CAPACITY ADDITIONS



UNDEVELOPED HYDROELECTRIC CAPACITY HAS BEEN ESTIMATED AT 449,000 MW BY THE ARMY CORPS OF ENGINEERS[4]

- CURRENTLY PROPOSED HYDRO PROJECTS BEFORE THE FEDERAL ENERGY REGULATORY COMMISSION (EXCLUDING PUMPED STORAGE AND FEDERAL PROJECTS) AMOUNT TO APPROXIMATELY 8,800 MW OF CAPACITY[5]
- INVESTOR-OWNED UTILITIES AND PRIVATE INDUSTRY ACCOUNT FOR 3,770 MW OR 43 PERCENT OF THESE PROPOSED ADDITIONS[5] [6]

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(4) NATIONAL HYDROELECTRIC POWER RESOURCES STUDY, U.S. ARMY CORPS OF ENGINEERS (JULY 1979)

(5) FEDERAL ENERGY REGULATORY COMMISSION LISTING (FEBRUARY 29, 1980)

(6) COOPERATIVES WHICH ARE CONSIDERED "PRIVATE" DEVELOPERS, FOR TAX PURPOSES, ACCOUNT FOR 9 PERCENT OF PROPOSED ADDITIONS.

II. ESTIMATED IMPACT OF EXTENDING TAX-EXEMPT FINANCING

TO MEASURE THE TAX IMPACT OF S. 2766, WE ESTIMATED BOTH THE TAX REVENUES WHICH WOULD BE:

- FOREGONE DUE TO THE TAX-EXEMPT FINANCING OF PROJECTS BY INVESTOR-OWNED UTILITIES AND PRIVATE INDUSTRY (7)
- RECEIVED AS A RESULT OF THESE PROJECTS

THESE ESTIMATES WERE PREPARED FOR:

- CURRENTLY PROPOSED HYDROELECTRIC PROJECTS
- A RANGE OF POTENTIAL (BUT CURRENTLY UNPLANNED) PROJECTS

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(7) WE HAVE NOT ADDRESSED THE TAX IMPLICATIONS ASSOCIATED WITH PUBLIC POWER ENTITIES AND CO-OPS WHICH ARE ALSO SUBJECT TO TAX-EXEMPT FINANCING LIMITATIONS

TAX REVENUES FOREGONE ARE ESTIMATED AT APPROXIMATELY $10 MILLION TO $30 MILLION ANNUALLY

CALCULATION OF ESTIMATED TAX REVENUES FOREGONE

(1) PLANNED CAPACITY ADDITIONS*	2 MILLION KW
(2) COST PER KW	$1,000/KW
(3) INVESTMENT (1) x (2)	$2 BILLION
(4) AVERAGE ANNUAL DEBT OUTSTANDING 0.50 X (3)	$1 BILLION
(5) TAX LIABILITY FACTOR	1% – 3%
(6) AVERAGE TAX REVENUES FOREGONE ANNUALLY (4) x (5)	$10 - $30 MILLION

* FOR INVESTOR-OWNED AND PRIVATE INDUSTRY PROJECTS EXCEEDING 100 MW

CURRENTLY PROPOSED PROJECTS

TAX REVENUES FOREGONE DUE TO TAX-EXEMPT FINANCING OF PROPOSED HYDRO PROJECTS (EXCEEDING 100 MW) BY INVESTOR-OWNED UTILITIES AND PRIVATE INDUSTRY IS ESTIMATED AT $10 TO $30 MILLION ANNUALLY. THIS RANGE IS BASED ON THE FOLLOWING ASSUMPTIONS:

- ALL PROPOSED PROJECTS WILL GO FORWARD AT THE SAME TIME
- CAPITAL COSTS WILL AVERAGE $1000/KW
- BOND ISSUES WILL ACCOUNT FOR 50 PERCENT OF CAPITAL REQUIREMENTS AND WILL CARRY A 10 PERCENT INTEREST RATE (TAXABLE)
- TAX REVENUES FOREGONE WILL RANGE BETWEEN 1 PERCENT AND 3 PERCENT OF THE AMOUNT OF TAX-EXEMPT BONDS ISSUED
  - THE LOWER ESTIMATED IS DERIVED FROM "THE INTEREST RATE AND TAX REVENUE EFFECTS OF MORTAGE REVENUE BONDS" BY ROGER C. KORMENDI AND THOMAS T. NAGLE (APRIL, 1980)
  - THE UPPER ESTIMATE IS BASED ON INTEREST RATE OF 10 PERCENT TIMES A TAX LIABILITY RATE OF 30 PERCENT

WE BELIEVE OUR ESTIMATE OF FOREGONE REVENUES IS HIGHER THAN MIGHT ACTUALLY OCCUR FOR SEVERAL REASONS:

- ALL PROJECTS WILL NOT NECESSARILY GO FORWARD
- PROJECTS WHICH DO GO FORWARD WILL NOT BE BUILT SIMULTANEOUSLY

ONE-TIME TAX REVENUES GAINED WILL NOT BE AFFECTED AND ARE ESTIMATED AT $200 MILLION

CALCULATION OF ONE-TIME TAX RECEIPTS

(1) INVESTMENT	$2 BILLION
(2) TAX FACTOR (SEE BELOW)	14%
(3) TAX REVENUES GAINED (ONE-TIME)* (1) x (2)	$200 MILLION

PER $100 OF HYDRO INVESTMENT	LAND	A/E	MATERIALS/ SUPPLIES	LABOR	TOTAL
(A) CAPITAL COSTS	$13	6	54	27	$100
(B) PER CENT TAXABLE AS INCOME	10%	25	25	80	
(C) TAXABLE INCOME (A) x (B)	$1.30	1.50	13.50	21.60	
(D) TAX RATE	50%	46	46	30	
(E) TAXES (C) x (D)	$0.65	0.69	6.21	6.48	$14.03
(F) COMPOSITE TAX RATE					14%

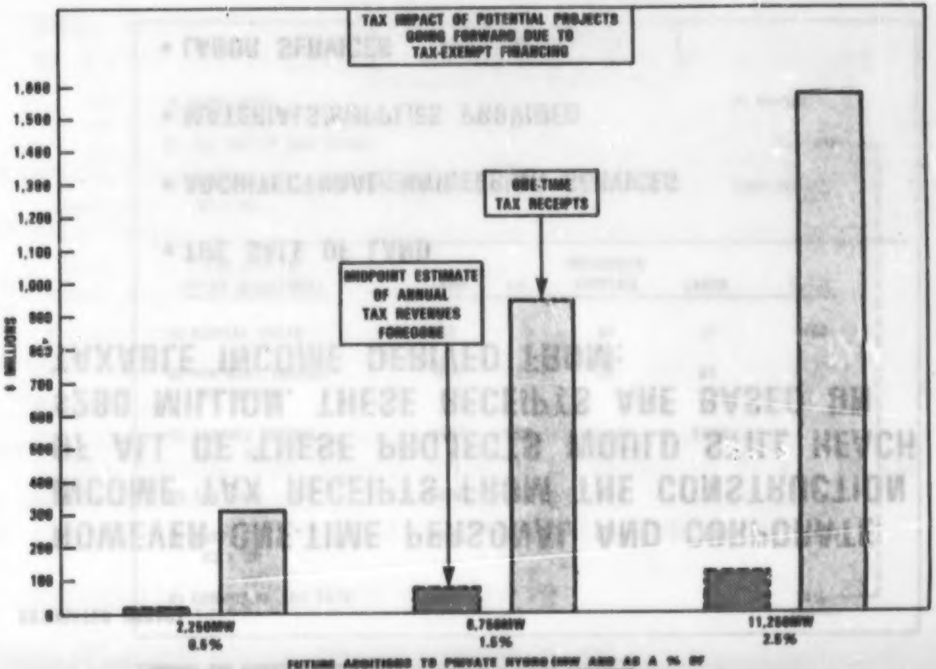
*DURING THE CONSTRUCTION PERIOD

ESTIMATED IMPACT . . .

HOWEVER ONE-TIME PERSONAL AND CORPORATE INCOME TAX RECEIPTS FROM THE CONSTRUCTION OF ALL OF THESE PROJECTS WOULD STILL REACH $280 MILLION. THESE RECEIPTS ARE BASED ON TAXABLE INCOME DERIVED FROM:

- THE SALE OF LAND
- ARCHITECTURAL/ENGINEERING SERVICES
- MATERIALS/SUPPLIES PROVIDED
- LABOR SERVICES

TREASURY RECEIPTS WOULD INCREASE SUBSTANTIALLY AS OUR HYDRO POTENTIAL IS FURTHER UTILIZED



POTENTIAL (BUT CURRENTLY UNPLANNED) PROJECTS

SINCE MORE ATTRACTIVE FINANCING WOULD BE AVAILABLE UNDER THE PROPOSED LEGISLATION, SOME PROJECTS COULD BE EXPECTED TO GO FORWARD, WHICH OTHERWISE WOULD NOT UNDER CONVENTIONAL FINANCING. BECAUSE OF THE DIFFICULTY IN PREDICTING WHICH PROJECTS WOULD GO FORWARD AS A RESULT OF THE PROPOSED LEGISLATION, A RANGE OF ESTIMATED CAPACITY ADDITIONS HAS BEEN DEVELOPED. THIS RANGE IS BASED ON CERTAIN PERCENTAGES OF OUR NATION'S UNDEVELOPED HYDROELECTRIC POTENTIAL OF 449,000 MW(8)

AS SHOWN ABOVE, TAX REVENUES LOST DUE TO TAX-EXEMPT FINANCING WOULD RANGE BETWEEN $23 MILLION AND $113 MILLION EACH YEAR (MIDPOINT ESTIMATES), DEPENDING UPON THE LEVEL OF FUTURE CAPACITY ADDITIONS. ONE-TIME RECEIPTS WOULD INCREASE BETWEEN $315 AND $1,575 MILLION THOUGH, AS A RESULT OF GREATER CONSTRUCTION(9)

(8) NATIONAL HYDROELECTRIC POWER RESOURCES STUDY

(9) DOES NOT CONSIDER FOREGONE TAX RECEIPTS DUE TO DISPLACED GENERATION ALTERNATIVES

ESTIMATED IMPACT . . .

IN ADDITION, OTHER BENEFITS WHICH WOULD ACCRUE LOCALLY, NATIONALLY, AND TO THE TREASURY ARE SUBSTANTIAL AND INCLUDE:

- REDUCTION OF NATIONAL RELIANCE ON FOREIGN OIL
- IMPROVEMENTS IN OUR COUNTRY'S BALANCE OF PAYMENTS, DUE TO THE DISPLACEMENT OF FOREIGN OIL PURCHASES
- THE WELL-KNOWN MULTIPLIER EFFECT OF THE PROFITS EARNED AND WAGES PAID DURING THE CONSTRUCTION OF NEW PROJECTS
- THE FINANCING, CONSTRUCTION, AND OPERATION-RELATED TAXES OF ASSOCIATED NON-EXEMPT FACILITIES (SUCH AS TRANSMISSION) WHICH ARE COMPARABLE IN SIZE TO CAPACITY INVESTMENT DOLLARS
- THE GREATER TAX BASE RESULTING FROM INCREASED ECONOMIC ACTIVITY WHERE THE POWER CENTERS ARE LOCATED
- FURTHER UTILIZATION OF A PROVEN TECHNOLOGY WITH MINIMAL ENVIRONMENTAL IMPACT

III. SUMMARY OF FINDINGS

- EXTENDING TAX-EXEMPT FINANCING TO PRIVATE HYDRO PROJECTS WILL RESULT IN REDUCED TAX REVENUES. WE CONSERVATIVELY ESTIMATE THESE LOSSES DUE TO TAX-EXEMPT INTEREST INCOME AT APPROXIMATELY $10 TO $30 MILLION PER YEAR

- HOWEVER, TAX RECEIPTS DERIVED FROM THE CONSTRUCTION OF PROPOSED HYDROELECTRIC PROJECTS WILL NOT BE AFFECTED AND AND ARE ESTIMATED AT $280 MILLION (ONE-TIME) DURING THE CONSTRUCTION PERIOD

- IN ADDITION, SOME PROJECTS WILL GO FORWARD WHICH WOULD OTHERWISE NOT UNDER CONVENTIONAL FINANCING. TAX RECEIPTS GENERATED FROM THESE PROJECTS CAN BE SUBSTANTIAL, EVEN AT LOW LEVELS OF POTENTIAL HYDRO DEVELOPMENT

- ADDITIONAL HYDRO DEVELOPMENT WILL PROVIDE OTHER BENEFITS TO OUR NATION, MOST NOTABLY A REDUCED DEPENDENCE ON OIL-FIRED CAPACITY

Senator GRAVEL. The next witness is Dr. Roger Kormendi.

STATEMENT OF ROGER C. KORMENDI, ASSOCIATE PROFESSOR OF ECONOMICS, UNIVERSITY OF CHICAGO

Mr. KORMENDI. Mr. Chairman, my name is Roger Kormendi. I am an associate professor of economics at the University of Chicag Graduate School of Business. During the past 3 years I have intensively researched the key issues relating to tax exempt financing. I have written, jointly with my colleague, Professor Michael Mus a book entitled "The Taxation of Municipal Bonds: an Econom Appraisal" on the subject of the proposed taxable bond optio I have also written several papers jointly with my colleague Prof Thomas Nagle on issues relating to the cost of tax exempt financing. It is my work with Professor Nagle that is most directly relevant to this hearing, and I would like to have one of our papers included in the record.

Senator GRAVEL. Your papers will be included in the record. I wonder if you would do me a favor and send me all the papers you have written in reference to tax exempt bonding, not just the one which is relevant here.

Mr. KORMENDI. And the book, as well?

Senator GRAVEL. You have a book, too?

Mr. KORMENDI. That is right.

Senator GRAVEL. Send it. Autograph the book for me too, will you?

Mr. KORMENDI. I will.

Senator GRAVEL. Thank you.

[The material referred to follows:]

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THE INTEREST RATE AND TAX REVENUE EFFECTS OF TAX-EXEMPT REVENUE BONDS

by

Roger C. Kormendi

Thomas T. Nagle

UNIVERSITY OF CHICAGO

July 1980

We wish to thank Harvey Galper, Robert Hamada, Roger Ibbotson, Roger Klein, Michael Mussa, Myron Scholes, Eric Toder, Roman Weil, and Thomas Whistler for helpful discussions and Geoffrey Faux for his competent research assistance. We would also like to thank the Public Securities Association for providing financial support. The views in this paper are our own and we are responsible for all remaining errors.

THE INTEREST RATE AND TAX REVENUE EFFECTS OF TAX-EXEMPT REVENUE BONDS

by

Roger C. Kormendi
and
Thomas T. Nagle

University of Chicago

I. INTRODUCTION

The right to issue tax-exempt bonds, whether general obligation or revenue bonds, has traditionally been utilized by state and local governments for the purpose of financing public projects. In recent years, however, tax-exempt revenue bonds have been issued by local governments to finance industrial development, pollution control, and private mortgages. Such financing has provided substantial benefits to the communities that issued such bonds, and it no doubt has also involved costs. While to date the estimation of benefits has stirred little controversy, the estimation of costs, particularly the effects of increased tax-exempt financing on interest rates and federal tax revenues, has been widely debated. This debate calls for prompt resolution since policy makers are currently being called upon by conflicting interest groups to extend or restrict such tax-exempt financing. If policy makers are to make inteligent and informed decisions, they will require accurate estimates of the costs of such financing.

In this paper, we argue that an overly simplified view of capital markets has exaggerated most estimates of the interest rate and revenue effects of tax-exempt bonds. That view is based on the assumption that only two assets, taxable and tax-exempt bonds, need be considered in the analysis. Under this extreme assumption, the analysis implies that investors in tax brackets higher

best copy available

than the interest rate differential between taxable and tax-exempt bonds, will hold tax-exempt bonds exclusively. Conversely, investors in tax brackets lower than the interest differential will hold only taxable bonds. In this simple world, any increase in the amount of tax-exempt bonds would require an increase in tax-exempt interest rates large enough to induce a sufficient number of taxable bondholders to forego holding them in favor of tax-exempts. Moreover, such a shift would have the greatest possible effect on federal tax revenues since completely tax-exempt bonds would replace an equal dollar amount of completely taxable bonds.

We will argue in this paper that such a simplified view of capital markets is seriously misleading. We offer a more realistic view accounting explicitly for other assets that substitute for bonds in investors' portfolios. In particular, we argue that for most potential purchasers of tax-exempt bonds, the favorable tax treatment of equity assets makes them more substitutable for tax-exempt bonds than are taxable bonds. Consequently substitution from equity absorbs much of any increase in the quantity of tax-exempt bonds, requiring a much smaller increase in tax-exempt interest rates to absorb a new issue than previous researchers have assumed. We estimate that in 1978, each additional billion dollars of tax-exempt bonds would have increased tax-exempt interest rates by about one-half basis point, a small fraction of most other estimates. Moreover, since income from equity receives more favorable tax treatment than does income from fully taxable bonds, the tax effect of substituting equity for tax-exempt bonds is considerably less than when taxable bonds are substituted. Consequently our estimate of the tax revenue effect of additional tax-exempt bonds is less than half the estimate made by the Treasury and the Congressional Budget Office.

II. THE MARKET FOR MUNICIPAL BONDS AND OTHER ASSETS

Tax-exempt bonds are just one of a number of assets competing in the capital market for investment funds. These assets differ in their riskiness, liquidity, maturity, and tax treatment. Higher riskiness, lower liquidity, longer maturity, and higher levels of taxation are valued negatively by investors, requiring that market determined yields be greater to compensate for them. Individual investors, however, will generally evaluate these negative factors differently, and so prefer to hold different types of assets. The market determines interest rates that equate the demands for these various assets to their respective supplies.

In contrast to previous writers who analyze tax-exempt financing with a view of capital markets consisting only of taxable and tax-exempt bonds, we distinguish three types of capital assets: fully taxable bonds, tax-exempt bonds and "equity." For data purposes, equity is simply taken to be ownership of corporate stock. There are, however, many other assets that, like tax-exempt bonds and corporate equity, yield income (often in the form of capital gains) that is at least partially tax-sheltered. Among these assets are consumer durables, privately held firms, tax shelters, discount bonds, non-reported "taxable" bonds. Such assets also play a role similar to corporate equity in substituting for tax-exempt bonds.

We also distinguish among four basic categories of investors: (1) "households," (2) commercial banks, (3) fire and casualty insurance companies and (4) other nonbank financial companies such as life insurance companies, pension funds, retirement funds, savings and loans and mutual savings companies, etc. There are considerable differences within these investor classes as well as across them. We focus our attention, however, on their tax liabilities and the resulting structure of their portfolios.

Table 1, derived from Federal Reserve Board data, shows the portfolios of these four investor groups with respect to the three basic assets under analysis. "Equity" in Table 1 is the more narrow definition of corporate equity, though many of the assets in the "Taxable Bonds" category are, in fact, either discount bonds or "non-reported" bonds (especially among household investors) and hence are more like tax-exempt bonds and equity than like other taxables. Table 1 shows that households hold a considerable amount of each of the three assets, banks hold primarily tax-exempt and taxable bonds, fire and casualty insurance companies hold all three assets, and other nonbank finance companies hold primarily equity and taxable bonds. These holding patterns are explicable when the tax liability of each investor group is considered.

The nonbank financial institutions are basically tax-exempt or very low taxed institutions, so they do not hold a significant portion of their portfolios in tax-exempt bonds. Their equity and taxable mix of bonds is determined by the tradeoff between risk and yield that they desire either as agents for their owners or for institutional considerations. The fire and casualty insurance companies hold taxable assets to the point where the income earned from those assets is no longer balanced by underwriting expenses. As soon as earnings begin adding to profit, fire and casualty companies hold tax-exempt bonds and equity (yielding shielded income and deferable capital gains income, respectively). In this way, these companies shield virtually all their income from taxation. Banks are in a similar position, except that they are constrained by regulation from holding equity. They hold large quantities of tax-exempt bonds, but not enough to entirely shield their incomes. This may result from the fact that banks restrict themselves almost entirely to municipals of a short-term, the supply of which is insufficient to enable them to shield all their income.[4]

TABLE 1
ASSET HOLDINGS BY SECTOR
(in billions of dollars)

	Municipal Bonds	Equity	Taxable Bonds**
Households*	89	840	415
Commercial Banks	125	0	725
Fire and Casualty Insurance Companies	60	20	35
Nonbank Financial Institutions	15	190	1,412

*"Households" in Federal Reserve Data includes nonprofit institutions. In Table 8 below we use estimates from another source to disaggregate this category.

**Includes mortgages and taxable mortage bonds.

Source: U.S. Board of Governors, Federal Reserve System, "All Sectors, Financial Assets and Liabilities, 1979," available on request from the Board of Governors.

In Table 1, we have treated households as a single group. The "Households" category, which includes non-profit institutions, is not however a homogeneous group of investors. Investors in that category have widely different demands for investment assets because of differences in their preferences and tax brackets. Since a household's tax bracket determines the value it will place on tax exemption, differences in tax brackets are especially important for analyzing who holds, or might be induced to hold, municipal bonds.

The tax exemption is most highly valued by those households subject to high levels of taxation. Consequently, they are the households most willing to accept a lower yield in return for the exemption. Lower tax bracket individuals and tax-exempt institutions, which are included in "households" in this data, place a lower value on tax exemption. They are therefore unwilling to forego the higher yields of a taxable bond in order to obtain the tax exemption on a municipal bond. For only a small group of investors, those whose marginal tax rate is approximately equal to the percentage difference between the taxable and tax-exempt yields would taxable and tax-exempt bonds be valued equally. Table 2, which shows household holdings of various assets at alternative income classes, confirms this analysis. The higher the level of income, the larger is the portion of household portfolios invested in municipals relative to taxables.[5]

Households in all income classes hold equity in quantities vastly exceeding their bond holdings. Unlike the value of the tax exemption, the value households place on the higher risk that equity carries is not dependent on tax rates. Consequently, when constructing a portfolio, high tax bracket individuals choose a combination of tax-exempt bonds and equity depending on their risk preferences. Note also that equity and tax-exempt bonds largely

TABLE 2

AVERAGE ASSET HOLDINGS PER HOUSEHOLD BY INCOME CLASS

in thousands of dollars
(in percentage of marketable asset portfolio)

Income* (1962)	Municipals	Equity	Taxables
0-14,999	<.05	1.5	<.05
15-24,999	.37 (2.6%)	10.4 (91.2%)	.7 (6.1%)
25-49,999	3.7 (4.8%)	71.4 (91.7%)	2.7 (3.5%)
50-99,999	34.7 (16.7%)	161.8 (77.7%)	11.8 (5.7%)
100 +	88.0 (8.2%)	956.3 (90.1%)	17.6 (1.7%)

*1962 is the latest year for which a detailed survey of consumer characteristics is available.

Source: Dorothy S. Projector and Gertrude Weiss, Survey of Financial Characteristics of Consumers (Washington: Federal Reserve Board, 1966), Municipals and Equity are taken directly from Table A10. Taxables is the sum of "U.S. Government Certificates, Notes and Bonds," "Domestic Corporat Bonds" from Table A12.

dominate any holdings of taxable bonds for high income investors. This is because both equity and tax-exempt bonds generate income subject to favorable tax treatment. Thus changes in the portfolios for high income investors are most likely to occur at the margin between equity and tax-exempt bonds.

Lower tax bracket individuals (and institutions) place a lower value on tax exemption, but nevertheless hold some equity for the higher return that accompanies its higher risk. In fact, equity and taxable bonds largely dominate holdings of tax-exempt bonds by low income investors. This results because the after-tax return on taxable bonds for low income investors exceeds the return on tax-exempts. Thus changes in the portfolios of these investors will generally occur at the margin between equity and taxable bonds.

In most analyses of the demand for municipal bonds, it has been assumed that an increase in the quantity of tax-exempt or taxable bonds results in substitution *only* at the margin between taxable--tax-exempt bonds.[6] Since so few investors operate at that margin, most previous analysts have been led to expect that a large change in yields would be required to adjust to a change in the quantity of bonds outstanding. In the world of integrated capital markets, however, adjustment occurs not only at the direct taxable--tax-exempt margin but also at all the other margins in investors' portfolios. New municipal bonds would be absorbed not only by those few investors substituting taxable for tax-exempt bonds directly, but also by many investors substituting equity and other partially taxed assets (e.g., durables and tax shelters) for tax-exempt bonds. When one recognizes that the entire market, not just a small segment, can respond on all margins to a change in relative yields, the expected increase in the tax-exempt yield necessary to induce holding of more municipal bonds becomes much smaller. Moreover, since these other alternative assets also receive favorable tax treatment, the effects on federal tax revenues will be much smaller as well.

To summarize, let us consider the consequences of a tax-exempt revenue bond issue. If we hold constant for the moment the total volume of borrowing (taxable and tax-exempt), a tax-exempt revenue bond issue will simply cause a substitution of tax-exempt debt for taxable debt.[7] The increase in the stock of tax-exempt bonds outstanding will increase somewhat the interest rate on tax-exempt bonds; the corresponding decrease in the stock of taxable bonds outstanding will reduce somewhat the interest rate on taxable bonds. Those few households on the direct taxable--tax-exempt bond margin will simply shift their holding of taxables to tax-exempts. If this were the only margin of adjustment, a significant interest rate effect would be necessary to induce additional households not now at that margin to give up their taxable bonds and absorb all the tax-exempt bonds, and the effects on federal tax revenues would be large. Fortunately, this is not the case.

The rise in tax-exempt interest rates would also induce a shift by high tax bracket households (and perhaps marginal tax bracket households and fire and casualty insurance companies) away from equity and toward tax-exempt bonds. At the same time, the fall in taxable yields would induce a shift towards equity and away from taxable bonds for low tax bracket households and institutions and for other nonbank financial institutions (see Table 1). With these other margins operating, little adjustment need occur at the direct taxable--tax-exempt margin. Given the size of the overall capital market, the total holdings of equity, and the number of investors at the equity--taxable bond and equity--tax-exempt margins, the necessary yield changes can be expected to be very small. Furthermore, the effects on federal tax revenues will be smaller due to the favorable tax treatment of equity assets.

In the next section, we consider the empirical evidence on the interest rate change required to absorb new tax-exempt bonds. Then, in the following section, we examine in more detail the portfolio readjustments likely to result from new municipal bonds and calculate the effect of those readjustments on federal tax revenues.

III. EMPIRICAL ESTIMATES OF THE INTEREST RATE EFFECTS OF TAX-EXEMPT REVENUE BONDS

Since modern capital markets involve many different assets, a complete empirical specification of the market would involve a large simultaneous equation system with the concomitant identification problems and the problem of measuring *ex ante* yields.[8] Such a project is beyond the scope and purpose of this paper. Therefore, we make two commonly employed assumptions that simplify the problem. First, we allow one alternative interest rate--the rate on a taxable bond--to serve as a proxy for the level of *ex ante* interest rates on all alternative assets. This should pose no problem since changes in the quantity of municipal bonds are probably too small to affect significantly the structure of yields on alternative assets. Second, we assume that supplies of municipal bonds and of the total quantity of assets outstanding are invariant to changes in tax-exempt relative to taxable rates of interest.[9]

These assumptions allow us to estimate with a simple OLS equation the effect of the municipal bond supply on the relative tax-exempt interest rate. In this equation, one should naturally expect municipal interest rates to increase when the stock of municipal bonds increases relative to the stock of all financial assets, since the relative return to municipal bonds must rise to induce investors to purchase them in lieu of other assets. In addition, our equation should be specified to measure the delayed affects of portfolio readjustments and the effect of inflation.

In order to account for lagged adjustments, we include in the equation a distributed lag on relative stocks of municipal bonds. Though the contemporaneous coefficient should be positive, the sum of the lagged coefficients should be negative, but not as large as the contemporaneous coefficient, since even after investors have fully adjusted their portfolios some interest rate effect should remain.

To account for the effects of expected inflation we include a measure of that variable, π_t. Expected inflation has two effects that operate in opposite directions: (1) simply adding the same inflation premium to the tax-exempt and the taxable interest rates would raise the value of the ratio of those two rates, but (2) since taxes are applied to the nominal interest return on fully and partially taxable investments, including the inflation premium reflected in that return, high rates of inflation make tax-exempt investments relatively more attractive. This enables them to be absorbed at lower relative interest rates.

The equation we estimate can therefore be written as follows:

$$(1) \qquad r^M_t / r^T_t = a_0 + \sum_{i=0}^{3} a_{1i} (M/A)_{t-i} + a_2 \pi_t + e_t \; ,$$

where r_M is the tax-exempt municipal rate of interest, r_t is the taxable rate of interest, M is the stock of municipal debt outstanding, A is the stock of all financial assets outstanding, and π_t is a measure of expected inflation. Some comments on the series utilized in the estimation of equation (1) are required. We use quarterly data, the implicit assumption being that all portfolio readjustment occurs over the course of one year. The rate r^M_t is the prime grade, 20 year maturity, municipal rate from Salomon Bros. The rate r^T_t is the New Long Aaa Utility yield series from Salomon Bros. These were chosen for their comparability in maturity and risk. The expected inflation variable was generated assuming an adaptive expectations model with exponential decay. Using changes in the Consumer Price Index, we calculated expected rates of inflation based on an assumed mean lag of 16 quarters.

Table 3 presents the empirical estimates of equation 1 both excluding (1a) and including (1b), the expected inflation variable. In this table and in those that follow, we report the minimum length of the lag structure that generated the same equilibrium interest rate effect as when all three lags were included. We report the results in this way because although the magnitude of the lagged effect was invariant to added lags, collinearity among the lags precluded identification of the actual length of adjustment.

As expected, both (1a) and (1b) reveal a positive coefficient for the current period value of M/A, which indicates that as the supply of municipal bonds increases as a portion of the total stock of assets, the municipal rate, r_t^M, increases relative to alternative assets yields. Given the levels of assets and interest rates in the last quarter of 1978, (1a) implies that each \$1 billion of new tax-exempt revenue bonds would initially increase tax-exempt interest rates by about .9 basis points. The negative coefficients on the lagged value of M/A indicate that as investors adjust their portfolios to the increase in municipal bonds, this initial effect is reduced in equilibrium to less than one-third of a basis point per \$1 billion of tax-exempt revenue bonds.

Holding expected inflation constant, as in (1b), the estimated interest rate effect per billion dollars of mortgage revenue bonds increases somewhat. (1b) implies that, at fourth quarter of 1979 levels, one billion dollars of tax-exempt revenue bonds would raise tax-exempt interest rates by about one basis point. After complete portfolio adjustment that effect is reduced to about .6 basis points per billion dollars of bonds. (1b) also implies that in the absence of expected inflation, the tax-exempt interest

TABLE 3
THE RELATIONSHIP BETWEEN INTEREST RATES AND THE QUANTITY OF MUNICIPAL BONDS

(1a)

$$r^M_t/r^C_t = \underset{(6.8)}{.57} + \underset{(2.3)}{8.3}\,(M/A)_t - \underset{(-1.6)}{5.6}\,(M/A)_{t-1} + \varepsilon_t - \rho\varepsilon_{t-1}$$

Sample: 1952-1978, quarterly $\bar{R}^2 = .35$ $\rho = .53$

Effect per $1 billion of Tax-exempt
Revenue Bonds:* Impact: .9 basis points
Equilibrium: .3 basis points

(1b)

$$r^M_t/r^C_t = \underset{(7.7)}{.51} + \underset{(2.6)}{9.1}\,(M/A)_t - \underset{(-1.1)}{3.9}\,(M/A)_{t-1} - \underset{(-3.3)}{.88}\,\pi_t + \varepsilon_t - \rho\varepsilon_{t+1}$$

Sample: 1952-1978, quarterly $\bar{R}^2 = .40$ $\rho = .41$

Effect per $1 billion of Tax-exempt
Revenue Bonds: Impact: 1.0 basis points
Equilibrium: .6 basis points

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*The basis point effects are for the level of interest rates and assets at the fourth quarter of 1978.

Sources: r_M = Prime Grade, 20 year maturity, municipal rate from Salomon Brothers, Analytical Record of Yields and Yield Spreads, Part III.

r_t = New Long Aa Utility yields from Salomon Brothers, Analytical Record, Part II.

M_t = The stock of State and Local Government obligations from the Board of Governors, Federal Reserve System.

A_t = The Stock of Total Financial Assets from the Board of Governors, Federal Reserve System.

π_t = The expected rate of inflation calculated using the Consumer Price Index and assuming an adaptive expectations model.

rate for the fourth quarter of 1978 would have been about 67% of the taxable rate, instead of the 61% that actually occurred.

In order to verify that the results reported in Table 3 reflect the true nature of the data and are not spurious, we undertook a number of sensitivity checks:

(1) We analyzed the time series properties of all the primary data to check for stationarity. The data we used generated stationary relative yields and relative stocks. Data we examined from other studies showed disturbing nonstationarities in relative yields.[11] This is probably due to the fact that our taxable and tax-exempt interest series are more comparable in maturity and grade.

(2) We ran the regression over different subperiods to check its stability. For all subperiods, F tests for the stability of the coefficient failed to reject the null hypothesis at the 5% level. [See Table 4.]

(3) We tried alternative functional forms; results were qualitatively robust to almost every alternative. [See Table 5.]

(4) We used alternative data for the interest rate series. Though the time series properties of these data and the regression properties were inferior, our results were qualitatively robust. [See Table 6.]

Our estimated interest rate effect of .3 to .6 basis point per $1 billion of new bonds implies that even in the event of a large increase in the quantity of municipal bonds, the total effect on the tax-exempt interest rate would not be disruptive. Even one hundred billion dollars of new mortgage revenue bonds would raise tax-exempt interest rates relative to taxable rates by little more that one-half of one percentage point at the level of rates in the fourth quarter of 1978. These estimates are noteworthy is that they are about one-tenth the estimates cited by critics of tax-exempt revenue bonds.[13]

TABLE 4
REGRESSIONS OVER ALTERNATIVE SUBPERIODS[1]

1952-1967

$$r^m_t/r^t_t = \underset{(8.7)}{.49} + \underset{(2.1)}{9.1}\ (M/A)_t - \underset{(1.0)}{3.8}\ (M/A)_{t-1}$$

Sample: 1952-1967, quarterly R^2 = .36 SSR ρ = .30
Interest Rate Effect per $1 billion TERBs: .6 basis points[2]

$$r^m_t/r^t_t = \underset{(7.3)}{.57} + \underset{(2.0)}{8.4}\ (M/A) - \underset{(1.1)}{4.4}\ (M/A)_{-1} - \underset{(1.5)}{2.0}\ \pi_t$$

Sample: 1952-1967, quarterly R^2 = .38 SSR ρ = .25
Interest Rate Effect per $1 billion TERBs: .4 basis points

1963-1978[3]

$$r^m_t/r^t_t = \underset{(2.1)}{.62} + \underset{(2.3)}{12.0}(M/A)_t - \underset{(-.1)}{.5}(M/A)_{t-1} - \underset{(-.5)}{2.3}\ (M/A)_{t-2} - \underset{(-1.6)}{8.1}(M/A)_{t-3}$$

Sample: 1963-1978 R^2 = .44 SSR ρ = .66
Interest Rate Effect on $1 billion TERBs: .1 basis point

$$r^m_t/r^t_t = \underset{(1.8)}{.49} + \underset{(2.5)}{12.9}\ (M/A)_t + \underset{(.1)}{.3}\ (M/A)_{t-1} - \underset{(-.2)}{.8}\ (M/A)_{t-2}$$

$$- \underset{(-1.4)}{7.0}\ (M/A)_{t-3} - \underset{(-1.6)}{.78}\ \pi_t$$

R^2 = .46 SSR ρ = .56
Interest Rate Effect on $1 billion TERBs: .6 basis points

1967-1978[3]

$$r^m_t/r^t_t = \underset{(1.6)}{.52} + \underset{(2.2)}{14.6}(M/A)_t - \underset{(-.4)}{2.8}(M/A)_{t-1} - \underset{(-.1)}{.6}(M/A)_{t-2} - \underset{(-1.2)}{7.5}(M/A)_{t-3}$$

Sample: 1967-1978 R^2 = .41 SSR ρ = .62
Interest Rate Effect of $1 billion of TERBs: .5 basis points

$$r^m_t/r^t_t = \underset{(1.5)}{.46} + \underset{(1.9)}{13.0}(M/A)_t + \underset{(.1)}{.6}(M/A)_{t-1} - \underset{(-.1)}{.6}(M/A)_{t-2} - \underset{(-1.1)}{7.3}(M/A)_{t-3} - \underset{(-1.5)}{1.2}\ \pi_t$$

Sample: 1967-1975 R^2 = .45 SSR ρ = .55
Interest Rate Effect of $1 billion of TERBs: .6 basis points

Notes: (1) t-statistics in parentheses.
(2) Bass rout effect on equilibrium effects.
(3) Later subperiods required 3 quarters lags before equilibrium basis points effects were reached.

TABLE 5

ALTERNATIVE FUNCTIONAL FORMS OF THE INTEREST RATE EQUATION

With r_m as the Dependent Variable

$$r^m_t = \underset{(28.3)}{.62}\, r_t + \underset{(2.1)}{44.4}\, (M/A)_t - \underset{(-1.8)}{36.8}\, (M/A)_{t-1}$$

Sample: 1952-1978, quarterly

$R^2 = .98$ $\rho = .61$

Interest rate effect per $1 billion of TERBs: .1 basis point

$$r^m_t = \underset{(19.0)}{.65}\, r_t + \underset{(1.9)}{40.6}\, (M/A)_t - \underset{(-1.6)}{35.3}\, (M/A)_{t-1} - \underset{(-1.1)}{4.4}\, \pi_t$$

Sample: 1952-1978

$R^2 = .98$ $\rho = .56$

Interest rate effect per $1 billion of TERBs: .1 basis point

In Log Form

$$\log(r^m_t/r^t_t) = \underset{(-.04)}{-.019} + \underset{(2.18)}{.42} \log\, (M/A)_t - \underset{(-1.64)}{.30} \log(M/A)_{t-1}$$

Sample: 1952-1978, quarterly

$R^2 =$ $\rho =$

Interest rate effect per $1 billion of TERBs: .2 basis points

$$\log(r^m_t/r^t_t) = \underset{(1.3)}{.43} + \underset{(2.5)}{.47} \log(M/A)_t - \underset{(1.3)}{.23} \log(M/A)_{t-1} - \underset{(-3.2)}{.041} \log \pi_t$$

Sample: 1952-1978

$R^2 = .40$ $\rho = .42$

Interest rate effect per $1 billion of TERBs: .5 basis points

Notes: (1) t-statistics in parentheses.

(2) Basis point effects are equilibrium effects.

TABLE 6

REGRESSIONS USING OTHER INTEREST RATE SERIES

George Peterson's Series[1]

$$r^m_t = \underset{(3.2)}{.55} + \underset{(1.5)}{4.8}(M/A)_t - \underset{(-.1)}{.3}(M/A)_{t-1}$$

Sample: 1958-1978, quarterly

$R^2 = .86$ $\quad\rho = .92$

Interest rate effect per \$1 billion of TERBs: .5 basis points

$$r^m_t/r^t_t = \underset{(2.6)}{.65} + \underset{(1.8)}{6.2}(M/A)_t - \underset{(-.3)}{.8}(M/A)_{t-1} + \underset{(.5)}{1.7}(M/A)_{t-2} - \underset{(-1.5)}{5.0}(M/A)_{-3} - \underset{(-2.7)}{1.6}\,\pi_t$$

Sample: 1958-1978

$R^2 = .85$ $\quad\rho = .81$

Interest rate effect per \$1 billion of TERBs: .2 basis points

Federal Reserve Board Series[2]

$$r^m_t/r^t_t = \underset{(2.9)}{.50} + \underset{(2.0)}{6.7}(M/A)_t - \underset{(-.3)}{.8}(M/A)_{t-1}$$

Sample: 1955-1972, quarterly

$R^2 = .75$ $\quad\rho = .89$

Interest rate effect per \$1 billion of TERBs: .6 basis points

$$r^m_t/r^t_t = \underset{(2.7)}{.65} + \underset{(2.2)}{7.3}(M/A)_t + \underset{(.03)}{.1}(M/A)_{t-1} - \underset{(-1.3)}{4.4}(M/A)_{t-2} - \underset{(-.1)}{.4}(M/A)_{t-3} - \underset{(-1.5)}{1.0}\,\pi_t$$

Sample: 1955-1978

$R^2 = .77$ $\quad\rho = .83$

Interest rate effect per \$1 billion TERBs: .3 basis points

Notes: (1) See Peterson [1979] for references.

(2) Federal Reserve Board, Federal Reserve Bulletin, Aaa State and Local Government and Aaa Seasoned Corporate Bonds.

(3) t-statistics in parentheses.

(4) Basis point effects are equilibrium effects.

Common sense indicates that an interest rate effect of .3 to .6 basis points per billion dollars of tax-exempt bonds must be closer to the true effect than the commonly cited larger estimates of 5 to 7 basis points. If the interest rate effect were that large, the *entire* difference between taxable and tax-exempt interest rates would be eliminated by only $75 billion of new tax-exempt bonds. But an increase of $75 billion represents only 15 percent of household-held assets yielding taxable income and only 2 percent of all assets yielding taxable income. It seems highly implausible that for a shift of that magnitude, investors would cease valuing the tax exemption of municipal bonds and therefore cease accepting a lower interest rate on bonds carrying that exemption.

IV. THE EFFECTS OF TAX-EXEMPT BONDS ON FEDERAL TAX REVENUES

Critics of tax-exempt revenue bonds have also focused considerable attention on the tax revenue effects of these bonds. At issue is the fact that if Congress were to eliminate or restrict the rights of localities to issue tax-exempt bonds, the Treasury would take in additional tax revenues. How much additional revenue depends on what alternative investments are bought when fewer tax-exempt bonds are available. At one extreme, if investors substituted only between tax-exempt and fully taxable bonds, then restriction of the tax-exempt bond market would result in a very large gain for the Treasury. It is this extreme assumption that is made by most critics of tax-exempt bonds.[15]

In point of fact, however, tax-exempt bonds are likely to substitute to some degree for many assets, not just for fully taxable bonds. They will generally substitute more for those assets most similar to municipal bonds from the viewpoint of the investors holding them. Corporate equity, tax shelters, and durable assets are the most similar assets to municipal bonds in their tax treatment. Taxable bonds, reported and "nonreported," are the most similar asset to municipal bonds in terms of risk. As we shall see, to the extent that assets with favorable tax treatment are substituted, the tax revenue effects will be smaller.

As a first step toward estimating who would purchase tax-exempt revenue bonds and what assets they would forego to do so, let us examine who currently holds municipal bonds and what assets they have available to substitute. In 1978, households held 31%, banks held 37% and fire and casualty insurance companies held 22% of municipal bonds of over one year maturity. Although no direct data exists on the question of who holds municipal debt with over 10 year maturity, the class relevant for most tax-exempt revenue bonds, one can infer from scattered data that the share held by households and fire and casualty insurance companies is much higher, and that of banks much lower, than their relative holdings of municipals in general. Any of these holders could be potential purchasers of a new issue of municipal bonds.

The major purchasers of new tax-exempt revenue bonds, however, would probably be households. First, since tax-exempt revenue bonds are highly concentrated at long maturities, banks are unlikely purchasers. Second, since fire and casualty insurance companies, as well as banks, would at most desire to purchase only enough tax-exempt bonds to shield their net income from taxation, they have a natural limit to expanding their purchases very significantly. Therefore, we will examine the case where households absorb all of the net increase in tax-exempt bonds. This is the assumption usually employed, but our analysis is easily adapted to alternative assumptions.[16]

Potential household holders of tax-exempt revenue bonds can be divided into two groups--a small group of marginal holders whose marginal tax rate is approximately equal to the percentage differential between the taxable and tax-exempt interest rates and a larger group of inframarginal holders whose marginal tax rate is higher than that. The former are indifferent between holding taxable and tax-exempt bonds since the after tax return they earn is the same in both cases. Although they would be likely to substitute tax-exempt for taxable bonds in significant proportion, they would also substitute equity for taxable bonds, since that is a relevant margin for them as well. In contrast, the households subject to higher tax rates would normally avoid fully taxable investments in favor of tax-exempt municipal bonds, corporate equity (or similar investments yielding income in the form of capital gains), discount bonds, tax shelters and durable goods yielding non-taxable income, and would substitute tax-exempt bonds for this broad spectrum of assets.

In Table 7, we present some estimates of the proportions in which marginal and inframarginal households absorb tax-exempt revenue bonds, the proportions of alternative assets that tax-exempt revenue bonds would replace in those households' portfolios, and the relevant marginal tax rates. For the purposes of deriving a reasonable estimate of the tax revenue effects, and because of the difficulties in obtaining direct estimates of the substitution coefficients, we employ the simplifying assumption that investors shift their portfolios in proportion to their holdings. Thus our estimates of the elasticities of substitution among assets are, through this assumption, all derived from published data on household holdings of alternative investments. We discuss these sources below as we calculate the tax revenue effect of a $1 billion issue of tax-exempt revenue bonds. When in doubt, estimates were biased in favor of high tax revenue effects.

Table 8 presents the available data on the relative magnitudes of equity, tax-exempt bonds, and taxable bonds held by income class. It is derived from

TABLE 7
TAX REVENUE EFFECTS PER BILLION DOLLARS OF ADDITIONAL TAX EXEMPTS REVENUE BONDS WHEN HOUSEHOLDS MAKE ALL ADJUSTMENTS

% of New Revenue Bonds Purchased (1)	By	Replacing	With a Replacement Percentage of (2)	At an Average Tax Rate of (3)	With a Tax Revenue Effect (in millions) (4)
90%	Inframarginal households	Corporate Equity	(82%)	12%	$8.9
		Tax shelters and durables	(10%)	0	0
		Taxables	(08%)	35%	2.5
10%	Marginal households	Corporate Equity	(50%)	10%	.5
		Tax shelters and durables	(0%)	0	0
		Taxables	(50%)	30%	1.5
			SUBTOTAL		$13.4
Plus allowance for portfolio adjustments by other investors					$3.5
Minus tax gain from lower interest deduction					<$14.4 to $5.0>
			TOTAL		$ 2.5 to $11.9

TABLE 8
DISTRIBUTION OF HOUSEHOLD-HELD FINANCIAL ASSETS BY INCOME CLASS

Income* (1962)	Municipals	Equity	Taxables**
0-14,999	7%	43%	44%
15,000-24,999	4%	11%	15%
25,000 +	89%	46%	41%

*1962 is the latest year for which a detailed survey of consumer characteristics is available

**An unknown portion of "taxables" held by high income investors are actually discount bonds, the return to which is mostly capital gains, not fully taxable interest.

Source: Projector and Weiss [1966]. Calculated by multiplying the average household holdings by income class (from Table A10) times the number of consumer units in the population at each income class (Table A36). For the largest income class ($100,000 and over), which is indicated as having less than .05 million consumer units, we assume .025 million units. Since this class is grouped with the much more populous ones preceeding it, the effect of error in this assumption would be trivial.

the Projector-Weiss survey of 1962 household holdings of assets. The three classes listed are taken to correspond to low, marginal and high tax bracket income classes in terms of 1962 effective marginal tax rates.[17] The data in columns (1) and (2) of Table 7 are derived from Table 8. For example, inframarginal high income households constitute about 89 percent of all household holders of municipal bonds. Marginal household hold only 4% of tax-exempt debt. Thus, in order to be conservative, we assumed for column (1) that 90 percent of new tax-exempt revenue bods could be absorbed by inframarginal households and that marginal households would absorb 10 percent. Inframarginal holders hold over ten times as much equity as debt. Thus, we assume in column (2) that the absorbed tax-exempt bonds replace equity and taxable in that proportion. Marginal household also hold more than ten times as much equity as debt. But as tax brackets approach the interest differential, taxable and tax-exempt bonds become close, though not perfect, substitutes. Thus, we conservatively assume tax-exempts replace only half equity and the other half taxable debt. Since we have no hard data on the quantities of assets such as tax shelters, durable goods, nonreported taxable bonds, etc., we assume that tax-exempts only replace 10 percent of those assets in inframarginal households and none for marginal households.

The tax rates we employ in column (3) of Table 7 reflect the tax treatments of different kinds of assets and of individuals at different incomes. The marginal tax rate for a fully taxable investment held by a marginal household is approximately thirty percent, the same as the difference between the taxable and tax-exempt interest rate. For the tax rate applicable to a taxable investment held by an inframarginal investor, we have chosen thirty-five percent.[18] The reasons for this choice are that 1) for holdings of securities yielding fully taxable income, the higher the marginal tax rate, the less likely is a household to be holding a taxable investment and 2) the "taxable" bonds held by higher tax bracket investors are generally "discount bonds" that yield very low coupon rates. Discount bonds are held for their capital gains, and hence are taxed more like equity than like taxable bonds. For equity, the tax rate on accrued capital gains has been estimated as 10 percent.[19] This is because capital gains receive favorable tax treatment, capital gains are generally deferred so that only a small fraction is realized in any given year, and people generally realize the accrued capital gains in years, such as in retirement, when their marginal tax rates are low. Since this 10 percent estimate was made, the portion of capital gains subject to tax has been reduced from fifty to forty percent and maximum tax rates have been reduced. Thus, current capital gains are probably at a rate less than 8 percent. Since, however, the yield on equity is somewhat higher than the yield on taxable debt, we assume in our calculations a tax rate of 12 percent for inframarginal households and a 10 percent rate for marginal households.[20] Table 7 reveals that for each billion dollars of tax-exempt bonds households would pay about $13.4 million less taxes as a consequence of switching to tax-exempt bonds from various alternative assets.

The key assets given up by households when purchasing tax-exempt bonds are equity and taxable bonds. Other investors must absorb those assets, which will also have tax revenue implications. Since commercial banks and saving and loan associations generally cannot invest in equity as a matter of law, we assume that their portfolios are unaltered by a tax-exempt revenue bond issue (that is, to the extent that they lose the taxable debt that tax-exempt financing replaces, they simply replace it with the debt given up by households and other investors, with their tax liabilities unaffected). Life insurance companies, mutual saving banks and credit unions for various reasons hold only a very small amount of equity relative to their taxable debt holdings. Thus, we assume that these investors also will not change their portfolios in response to a tax-exempt revenue bond issue.

Table 9 provides evidence on the holdings of equity and taxable debt by investors who are in a position to absorb equity and give up taxable debt--nonprofit institutions (such as foundations, universities and unions), pension funds, low income households, and fire and casualty insurance companies. We assume that the absorption of equity and the release of taxable debt is in proportion to the total investor holdings of these assets as shown in column 3. Nonprofit institutions, pension funds, and insurance companies hold about 60% of the equity and taxable bonds held by the relevant investor groups. Changes in the portfolio of these institutions have almost no tax effect since they pay virtually no taxes.

Low income households hold about 35% of the equity and taxable bonds held by the relevant investor group. Thus, they would absorb about $350 million of equity for each billion dollars of tax-exempt revenue bonds and give up a like amount of taxable debt. The effect on their tax liabilities of such a change depends on the amount of their interest income actually reported. While nonreporting of interest income is commonly believed to be substantial, the Interval Revenue Service declines to publicize its estimates. We assume that one-fourth of such interest is unreported by low income taxpayers, who have an average marginal tax rate of about 25 percent on reported income. On equity income, they would pay about 8 percent assuming that they, like higher income taxpayers, shield their earnings by taking them as capital gains. Thus on the $350 million shift in their portfolios, they would pay about 10 percent [.2(1 - .25) - .08] less tax on that income than they would have paid on fully taxable debt. Thus a 10% return on taxable debt yields a reduction of

TABLE 9

ASSET HOLDINGS BY INVESTOR CLASS IN POSITION TO ABSORB FOREGONE EQUITY

(in billions of dollars)

	Equity		Taxable Bonds		Total of Equity and Taxable Bonds	
w Income Household	291	(47%)	101	(20%)	392	(35%)
nprofit Institution	160	(26%)	184	(36%)	344	(30%)
rivate Pension Funds	150	(24%)	194	(38%)	344	(30%)
re and Casualty Insurance Companies	21	(3%)	34	(7%)	55	(5%)
TOTAL	622	(100%)	513	(100%)*	1135	(100%)

ot 100% due to rounding.

about $3.5 million in tax revenues from these investors for each $1 billion of tax-exempt revenue bonds.

Tax-exempt revenue bonds also result in *greater* tax liabilities for those individuals and institutions that obtain the tax-exempt financing since with lower interest rates on tax-exempt debt, they must claim lower interest deductions. Assuming tax-exempt rates of 7% and taxable rates of 10% yields approximately $30 million less deduction per billion dollars of tax-exempt bonds. For industrial development bonds and pollution control bonds, the appropriate tax rate is approximately the 48% corporate tax. Thus, the tax revenue *gained* would be approximately $14.4 million for these types of revenue bonds. For mortgage revenue bonds, due to the participation of commercial banks and savings and loans, the interest rate differential is generally reduced, with approximately one third of the interest differential going as income to the intermediary and two thirds going as interest reduction to the borrower. Thus, applying a 30% household tax rate to the reduced interest payments of the borrower (2% of the principle) yields approximately $5 million as tax revenue *gains* on mortgage revenue bonds.

We have now accounted for the three main elements of the federal tax revenue effects of tax-exempt revenue bonds: (1) The loss of tax reveneues from investors who hold the new tax-exempt bonds and give up equity and taxable debt, (2) the loss of tax revenues from investors who give up taxable debt and absorb the equity and (3) the gain in tax revenues from the lower interest deduction that tax-exempt borrowers receive. The range of the net tax revenue loss to the Treasury is $2.5 million for industrial development and pollution control bonds to $11.9 for mortgage revenue bonds. The differences come solely from the third element, the reduced interest deduction component. These estimates of the revenue loss are notable because they are less

pages tightly bound

than half those produced by the Treasury and the Congressional Budget Office. The reason for this difference is simply that we have explicitly accounted for the substitutions of a broad spectrum of assets, most importantly, equity, whereas the generally cited estimates make the extreme assumption that only taxable bonds substitute for tax-exempt bonds in investors' portfolios.

V. SUMMARY AND CONCLUSIONS

We have argued that previous researchers' high estimates of the interest rate and tax revenue effects of tax-exempt revenue bonds resulted from an oversimplified view of capital markets. We presented a more complete view of the capital market as it relates to municipal bonds. Recognizing the substitutability of equity assets, broadly defined, for both tax-exempt and taxable bonds, we have argued that the equity--tax-exempt margin would probably absorb much of any increase in the quantity of municipal bonds, which reduces the adjustment required on the taxable--tax-exempt margin. As a consequence of the smaller adjustment required on the taxable--tax-exempt margin, one should expect an increase in tax-exempt bonds to have smaller effects both on interest rates and on federal tax revenues than critics have claimed.

Our estimates of the effect of a $1 billion increase in the volume of tax-exempt revenue bonds on municipal interest rates, .3 to .6 basis points per billion dollars of bonds in 1978, are only a small fraction of most other estimates. An important reason for that difference is that this study is currently the only one to distinguish between the impact and long-run effects of new bonds. Our estimates of the tax-revenue effects of tax-exempt revenue bonds are less than half the frequently quoted estimate made by the Congressional Budget Office. This difference results from our taking into account the fact that municipal bonds will often replace a broad spectrum of assets that generate less than fully taxable income.

Whether any particular type of private investment should be allowed tax-exempt financing is a question of social policy that must be decided by the political process. To make intelligent and informed decisions, however, policy makers require accurate estimates of the costs of such financing. We believe that our estimates of the interest rate and tax revenue effects of tax-exempt financing offer a far more accurate picture than has heretofore been presented.

Footnotes

[1] Peterson [1979], Hendershott and Koch [1977], Congressional Budget ffice [1979], Galper and Toder [1980], Hendershott [1980].

[2] Kormendi and Nagle [1979].

[3] Mussa and Kormendi [1979], Chapter 6.

[4] Ibid.

[5] Studies that have recognized other margins in their analyses are Mussa nd Kormendi [1979], Ott and Meltzer [1963], Kane [1980].

[6] The analysis that of an increase in mortgage revenue bonds exceeds the reduction in taxable bonds requires only slight modification.

[7] Hendershott and Koch make an interesting and bold attempt at simultaneous estimation of these relationships. They include, however, ex-post yields on equity as a proxy for ex-ante yields, which yielded no significant effect. Since the errors in the variable problem are tremendous, that the coefficients should be biased to zero is expected.

[8] This is an identification assumption that allows us to employ single equation estimation techniques. Recent work by Zellner suggests that single equation estimation is as good as two-stage least squares simultaneous estimation when dealing with small samples, as in this case.

[9] Longer lags are possible, but the data do not allow us to distinguish between the possibilities of one, two, or three lags. See point (7) supra.

[10] See Table 6 for regressions utilizing other interest rate series.

[11] See Plosser-Schwert [1977] and Plosser-Schwert-White [1979].

[12] Congressional Budget Office [1979]. Peterson [1979].

[13] We were unable to replicate these results with data from the sources cited by Peterson. In spite of attempts to estimate the equation in a number of forms, the coefficient of interest was always essentially zero. Peterson [1979], pp. 112-115 is the source for his reported regression results.

[14] See, for example, Congressional Budget Office [1979]. Peterson [1979].

[15] Federal Reserve Board [1979].

[16] Mussa and Kormendi [1979], Chapter 6.

[17] Ibid.

[18] See Table 2 infra, Projector and Weiss [1966], and Mussa and Kormendi [1979].

[19] Mussa and Kormendi [1979].

[20] Bailey [1969].

[21] Fama and Schwert [1977]. Fisher and Lorie [1977].

[22] Hendershott and Koch [1977].

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Mr. Kormendi. In our papers, Professor Nagle and I take issue with the U.S. Treasury's estimates of the cost of tax-exempt financing. We differ with the Treasury's estimates on two key issues: One, the effects of additional tax-exempt financing on interest rates, particularly on tax-exempt interest rates; and two, the effects of additional tax-exempt financing on Federal tax revenues.

With respect to the issue of the interest rate effects, the Treasury has generally assumed the tax-exempt rates would increase by about five basis points for each additional billion dollars of tax-exempt bonds. This assumption derives from a statistical estimate made by some economists at the Urban Institute.

Unfortunately, there are several economic and statistical errors in that analysis. Therefore, we reestimated the interest rate effects and discovered that the true effect was about 0.6 basis points, approximately one-tenth as large as that assumed by the Treasury.

With respect to the issue of the Federal tax revenue loss, the Treasury estimates that each $1 billion of additional tax-exempt bonds would involve a $30 million direct Federal tax revenue loss. What makes the analysis of the Treasury wrong is their assumption, contrary to the facts, that only those investors with marginal tax brackets near 30 percent would absorb newly issued tax-exempt bonds. In fact, Federal Reserve Board data shows that more than 85 percent of household-held tax-exempt bonds are held by investors with tax brackets much higher than 30 percent and about the same percentage of newly-issued tax-exempt bonds are generally absorbed by this group.

For this investor group, the relevant substitute asset for tax-exempt bonds is not taxable bonds, but corporate equity, because investors with higher tax brackets hold little tax-exempt debt and large quantities of corporate equity, and because the income from corporate equity is subject to favorable tax treatment as currrently provided by the tax law.

Moreover, since equity income is subject to much lower tax rates than fully taxable debt, the true Federal tax loss is much smaller than currently estimated by the Treasury. Using the Federal Reserve Board data, we find that the direct Federal tax loss is, at most, $15 million per $1 billion of new tax-exempt bonds. This is only one-half of the Treasury's inappropriate estimate.

It is dramatic to see how our estimates differ with the Treasury's in the context of an explicit example. This example was taken from a table entitled "Inefficiency of Mortgage Subsidy Bonds Under Modified Ullman-Conable Proposal," and it was submitted to the Senate Subcommittee on Intergovernmental Relations by Roger Altman, Assistant Secretary to the Treasury.

In this table the Treasury claims that only 33 cents of benefits accrue to home buyers for each dollar's worth of cost borne by Federal, State, and local governments. In contrast, using our more appropriate analysis of the interest rate and tax revenue effects, we find that home buyers actually receive $1.83 of benefits for each dollar of cost.

In other words, the Treasury has underestimated the benefit-to-cost ratio by a factor of 6. I have attached a table comparing the Treasury estimates with our own.

Senator **Gravel**. Very good, Doctor. It was a pleasure to hear our testimony. I have no questions and wish to compliment you on our good work in punching some holes in Treasury's case.

Mr. **Kormendi**. Thank you.

Senator **Gravel**. Thank you.

[The prepared statement of Mr. Kormendi follows:]

TESTIMONY OF ROGER C. KORMENDI BEFORE THE SENATE FINANCE COMMITTEE ON THE SUBJECT OF THE INTEREST RATE AND FEDERAL TAX REVENUE EFFECTS OF TAX-EXEMPT FINANCING

by

Roger C. Kormendi
Associate Professor of Economics
University of Chicago

June 24, 1980

TESTIMONY OF ROGER C. KORMENDI BEFORE THE SENATE FINANCE COMMITTEE ON THE SUBJECT OF THE INTEREST RATE AND FEDERAL TAX REVENUE EFFECTS OF TAX-EXEMPT FINANCING

by

Roger C. Kormendi

My name is Roger Kormendi. I am an Associate Professor of Economics at the University of Chicago, Graduate School of Business. During the past three years, I have intensively researched some of the key issues relating to tax-exempt financing. I have written jointly with my colleague, Professor Michael Mussa, a book entitled The Taxation of Municipal Bonds: An Economic Appraisal, on the subject of the proposed taxable bond option. I have also written several papers jointly with my colleague, Professor Thomas Nagle, on issues relating to the costs of tax-exempt revenue bonds. Our paper on mortgage revenue bonds was presented at the recent National Science Foundation Conference on the Efficiency of the Municipal Bond Market and will be published in the proceedings of that Conference. It is my work with Professor Nagle that is most directly relevant to this hearing, and I have included a copy of one of our papers for the record.

In our papers, Professor Nagle and I take issue with the U. S. Treasury's estimate of the cost of tax exempt revenue bond financing. We differ with the Treasury's estimates on two key issues: 1) the effect of additional tax-exempt revenue bond financing on interest rates, particularly tax-exempt interest rates, and 2) the effect of additional tax-exempt revenue bond financing on federal tax revenues.

With respect to the issue of the interest rate effect, the Treasury has generally assumed that the tax-exempt interest rate would increase by about five basis points for each additional billion dollars of tax-exempt revenue bonds issued. This assumption derives from a statistical estimate made by George Peterson of the Urban Institute. Unfortunately, Mr. Peterson made several economic and statistical errors in his analysis that we discuss in our papers. We therefore reestimated the interest rate effects and discovered that the true effect was about .6 basis points--approximately one-tenth as large as the effect assumed by the Treasury. As a matter of common sense, the Treasury's estimates of five basis points per billion dollars of tax-exempt bonds must be far off. If the interest rate effect were five basis points, the entire difference between taxable and tax-exempt interest rates would be eliminated by only 60 billion dollars of new tax-exempt bonds. This increase would represent less than 2% of all assets yielding taxable income, and it certainly could not reduce to zero the value of the tax exemption to all investors.

With respect to the issue of the federal tax revenue effect, the Treasury estimates that each $1 billion of additional tax exempt revenue bonds would involve a $30 million direct federal tax revenue loss. What makes the Treasury's analysis wrong is their counterfactual assumption, that only those investors with marginal tax brackets near 30% would absorb newly issued tax-exempt revenue bonds. In fact, Federal Reserve Board data shows that more than 85% of household-held tax-exempt bonds are held by investors with tax brackets higher than 30% and about the same percentage of new issues of tax-exempt revenue bonds are generally absorbed by this group. For this investor group the relevant substitute asset for tax-exempt bonds is not taxable bonds but corporate equity. This is because investors with high marginal tax brackets hold little taxable debt and large quantities of corporate equity, the income of which is subject to favorable tax treatment as provided by current tax law. Moreover, since equity income is subject to much lower tax rates than fully taxable debt, one should expect the true federal tax loss to be much smaller than currently estimated by the Treasury. Using the Federal Reserve Board data we have estimated that the direct federal tax loss is at most $15 million dollars per billion dollars of new tax-exempt revenue bonds. This is only one-half of the Treasury's inappropriate estimate.

It is dramatic to see how our estimates differ in the context of an explicit example. This example is taken from a table entitled "Inefficiency of Mortgage Subsidy Bonds Under Modified Ullman-Conable Proposal," submitted to the Senate Subcommttee on Intergovernmental Relations by Roger Altman, Assistant Secretary of the Treasury. In this table the Treasury claims that only 33¢ of benefits accrue to home buyers for each dollar of cost borne by federal, state, and local governments. In contrast, using our more appropriate analysis of the interest rate and revenue effects of tax-exempt financing, we find that home buyers actually receive $1.83 of benefit for each dollar of cost! In other words, the Treasury has underestimated the benefit to cost ratio by a factor of six. I have attached a table comparing the Treasury's estimates with our own.

COMPARISON OF KORMENDI-NAGLE VERSUS TREASURY ESTIMATION OF THE BENEFIT TO COST RATIO FOR MORTGAGE REVENUE BONDS

	Treasury	Kormendi-Nagle
Direct cost to Federal taxpayers	$30 million	$15 million
- plus -		
Cost to State and local governments due to higher interest rates on their tax-exempt debt	$19.5 million	$2.4 million
- minus -		
Investment profit on reserve funds	< $4.5 million >	< $4.5 million >
- minus -		
Higher taxes due to lower interest deductions	< $5.7 million >	< $5.7 million >
- equals -		
TOTAL COST	$39.3 million	$7.2 million
TOTAL BENEFIT (to home buyers)	$13.1 million	$13.1 million
BENEFIT/COST	33¢ per dollar	$1.82 per dollar

Senator **Gravel**. Our next panel is from the great State of Louisiana, who are Mr. Sidney Murray, mayor of Vidalia, and Mr. Sylvan Richard, director of Louisiana Energy and Power.

Gentlemen, please proceed.

STATEMENT OF SIDNEY MURRAY, MAYOR, VIDALIA, LA.

Mr. **Murray**. If it is proper for me to do so, I do not have written comments here, but if it is proper for me to ask that they be placed on the record, I will do so.

Senator **Gravel**. Why don't you send us the comments that you want placed in the record and we will have them placed there. I am sure the chairman would have no objection to that.

Mr. **Murray**. I will proceed to give my statement and then allow Mr. Richard to comment. First of all, I would like to say that my primary purpose in being here is to enthusiastically support Senate bill 2766. The town of Vidalia is a municipally-owned utility and has been since I can remember. For about the past 2 years, we have been actively working on a hydroelectric project which, if successful, will be the first ever in the State of Louisiana.

Senator **Gravel**. It will be the first hydro project in Louisiana?

Mr. **Murray**. Ever, in the State of Louisiana.

Senator **Gravel**. With all that water.

Mr. **Murray**. Right. It would be a great source of pride to us if the entire Louisiana delegation were to support this bill as enthusiastically as we do. Without going into all of the detail of what has happened in the last 2 years, we will say that the town has proposed this project, has sought the engineering necessary to have it constructed. We have secured a permit and are now in the licensing stage of this project.

We have learned of the restriction known as the 25 percent two-county rule. When we learned of this, we began to realize as we studied our problem the real gravity of the situation. Simply put, we could generate more electricity on this site than the town of Vidalia uses.

In fact, at the present time it will be about 75 percent more than we consume. Therefore, we have to have a source of sale for this power. It is very critical to the success of the project that we be allowed to do this, but under the 25 percent, two-county rule limitation, our hands are tied.

We hope, of course, eventually to go into the size, industrially and residentially and so forth, that we would consume the total output of our plant; but at the present time, at least initially, we would not have the capacity to use it all.

This basically is our statement, Senator, and we——

Senator **Gravel**. Let me ask this question, sir. Are you part of a grid system?

Mr. **Murray**. Yes. We are purchasing power right now from Louisiana Power & Light Co.

Senator **Gravel**. Wouldn't you be pumping that power into the grid and displacing fossil fuels?

Mr. **Murray**. Well, we have various alternate sources that we could furnish the power to. We could put it on LPL's grid. If I were allowed to sell them——

Senator **Gravel**. I am presupposing that, and if the cost-benefit ratio is there, it is very meritorious to go ahead and do that.

Mr. **Murray**. Yes, there is no question about it.

Senator **Gravel**. Saving fossil fuels in Louisiana is just as important as saving them in Alaska.

Mr. **Murray**. We estimate on this project, if our arithmetic is correct, it is around a million barrels per year, an 86-megawatt plant.

Senator **Gravel**. Is it 86 megawatts?

Mr. **Murray**. Yes, sir. And we have various alternate sources to sell it. We have been talking with investment firms, and of course they require contractors over a long term, and this is one of the problems. So again, we would very much like to see this bill enacted.

Senator **Gravel**. What is the cost of the project?

Mr. **Murray**. Around $300 million.

Senator **Gravel**. $300 million?

Mr. **Murray**. This is the only place at the present time that a site exists, to my knowledge, in the State on which hydro can be put.

Senator **Gravel**. I obviously, as a sponsor, am very enthusiastic about this and have been very favorably disposed to Louisiana's water problems, having been the chairman of water resources committee, so I am very familiar with your area. With what we passed last year in the windfall profits tax in terms of small hydro, and recognizing that Louisiana is not a mountainous State, I would hope there would be many areas that might qualify under the small hydro,

Mr. **Murray**. Since we have filed our permit 2 years ago, there are now some eight permits that I know of that have been filed in the State. There are locks and dams proposed on the Red River. As a matter of fact, the town has secured a second permit on lock and dam 4 on the Red River, along with some other municipalities. There are several municipalities involved.

I am sure Mr. Richard here, who is chairman of the board of the LEPA organization, could elaborate more on that end of it.

We have a real problem in the financing of this program, and we hope that this bill will pass. We thank you for your time.

Senator **Gravel**. I hope so, too. I am sure that if you talk to the chairman personally, who has always been a backer of my efforts in the past, that you will add to his considerable enthusiasm for this.

Mr. **Murray**. Thank you very much.

Mr. Richard.

STATEMENT OF SYLVAN RICHARD, DIRECTOR, LOUISIANA ENERGY & POWER AUTHORITY

Mr. **Richard**. I would like, Senator, to second the mayor's comments and statement, in that we do have other municipals in Louisiana looking at potential hydro development on the Red River and all the locks and dams that are being planned by the Corps of Engineers.

Some of these projects are also limited in the same manner in which the mayor indicated the city of Vidalia is, in that these projects will generate excess energy which they will have to sell, and it does violate the 25 percent, two-county rule and therefore they would lose their tax exemption on the financing.

So they are in favor and would support this bill.

Senator GRAVEL. Thank you very much, gentlemen. We appreciate it.

Our next witness in this group will be John Schaefer, vice president of E. F. Hutton & Co.

Mr. Schaefer, I understand Mr. Lopp was not able to be here and you are sitting in for him.

Mr. SCHAEFER. Yes, that is correct.

Senator GRAVEL. Please proceed.

STATEMENT OF JOHN SCHAEFER, VICE PRESIDENT, E. F. HUTTON & CO.

Mr. SCHAEFER. Mr. Chairman, in the interest of time, I would like to highlight Mr. Lopp's testimony, which supports Senator Gravel's hydro——

Senator GRAVEL. It will be placed in the record as submitted.

Mr. SCHAEFER. Thank you very much.

Inasmuch as the Finance Committee, by a vote of 9 to 2 last October 25, voted to include as an amendment to the windfall profits tax measure language similar to bill 2766, I will not take the subcommittee's time this afternoon to make a lengthy argument as to the merits of the proposed legislation. In fact, I think those have been covered fairly well.

Senator GRAVEL. In fact, the Senate has already acted on that issue. We lost it in conference. Our hope is to regain it this year.

Mr. SCHAEFER. In Mr. Lopp's testimony he addresses the objections which have been raised against the use of tax exempt bonds to finance hydroelectric facilities, objections which we understand were responsible for the refusal of the House members of the conference committee on the windfall profits tax bill to accept the Senate provisions.

In large part these objections are based upon a grossly erroneous concept of the bond market and upon highly inflated estimates of the revenue loss to be lost to the Treasury because of tax exempt status of the bonds. I think Professor Kormendi has already covered the inaccuracies of the Treasury's method of estimation.

With respect to the bond market itself, we really can do no better than to recount the comment of Senator Gravel in his additional views in the report of the windfall profits tax bill, where he said:

> The use of tax exempt financing for hydroelectric construction is attacked by the administration on the grounds that the expansion of the use of tax exempt financing into this field will increase interest rates, drive out other tax exempt borrowers such as schools and hospitals.
>
> The administration position has no basis in fact. Historically, when investments eligible for tax exempt financing have been expanded, the markets have expanded to absorb the new issues without affecting interest rates. In recent years, two major new markets for tax exempt bonds have developed without affecting interest rates. These two new major markets were pollution control facilities and housing mortgage bonds.

As investment bankers, we can endorse completely Senator Gravel's comment. He was also completely on the mark when he said:

> The interest rate on tax exempt bonds is not tied to the volume of bonds issued but to the cost of money generally. The Treasury and the Federal Reserve System do more to affect the interest rate on tax exempts than any conduct in the market.
>
> The market for tax exempt bonds is not a closed market with a limited volume all its own, but a market like other markets which interacts with the markets for other financial assets. The Treasury appears to view this market as closed, with a finite possible size, in spite of historical evidence to the contrary.

Again, E. F. Hutton as an investment banking firm can agree with these words and tell you that they are the truth. The use of tax-exempt financing for a broad spectrum of public purposes has served America well. It has prompted industrial development, created jobs, rebuilt neighborhoods, provided affordable housing, curbed pollution and accomplished a significant number of other worthwhile public purposes.

It is true that because of the tax-exempt status of these bonds, some would argue that there has been what amounts to a Federal subsidy. If this is true, then we feel that it should be continued. States and localities which have issued the bonds have benefited from their proceeds in a manner, we suggest, that is more efficient, cost effective and workable than a Federal subsidy program administered by a massive and often unresponsive bureaucracy.

In short, Mr. Chairman, we believe that the passage of bill 2766 would not only make a significant contribution to the solution of the Nation's energy problem but would do so in a way that is completely compatible with the expressed intent of tax exempt financing.

Senator **Gravel**. Thank you very much, Mr. Schaefer. I have no questions.

[The prepared statement of Mr. Lopp follows:]

Testimony of W. James Lopp II, Executive Vice President, E. F. Hutton & Co., Inc.

Mr. Chairman and members of the Subcommittee, I am Jim Lopp, Executive Vice President of E. F. Hutton & Company Inc. I sincerely appreciate this opportunity to express support of Senator Gravel's bill, the Hydropower Development Act of 1980.

Inasmuch as the Finance Committee, by a vote of 9 to 2, last October 25, voted to include as an amendment to the Windfall Profit Tax measure, language similar to S. 2766, I will not take the Subcommittee's time this afternoon to make a lengthy argument as to the merits of the proposed legislation. It is clear that you, the full Finance Committee and the full Senate already appreciate the need to develop the nation's neglected hydroelectric potential.

More than that, Senator Gravel, in his May 28 remarks upon introduction of the bill, has clearly and succinctly outlined the urgent requirement that this nation rediscover and bring back into use the massive potential for energy represented by hydroelectric power generation.

In these brief remarks, Mr. Chairman, I would like first to address the objections which have been raised against the use of tax-exempt bonds to finance hydroelectric facilities—objections which I understand were responsible for the refusal of the House members of the conference committee on the Windfall Profit Tax bill to accept the Senate provisions.

In large part these objections are based upon a grossly erroneous concept of the bond market and upon highly inflated estimates of the revenue to be lost to the Treasury because of the tax-exempt status of the bonds.

I can do no better, Mr. Chairman, than to recount the comment of Senator Gravel in his Additional Views in the report on the Windfall Profit Tax. He said:

"The use of tax-exempt financing for hydroelectric construction is attacked by the administration on the grounds that expansion of the use of tax-exempt financing into this field will increase interest rates, driving out other tax-exempt borrowers such as schools and hospitals. The administration position has no basis in fact. Historically, when the investments eligible for tax-exempt financing have been expanded, the markets have expanded to absorb the new issues without affecting interest rates. In recent years two major new markets for tax-exempt bonds have eveloped without affecting interest rates. These two major new markets were ollution control facilities and housing mortgage bonds."

As an investment banker, I can endorse completely Senator Gravel's comment. He was also completely on the mark when he said:

"The interest rate on tax-exempt bonds is not tied to the volume of bonds issued ut to the cost of money generally. The Treasury and the Federal Reserve System o more to affect the interest rate on tax-exempts than any conduct in the market. he market for tax-exempt bonds is not a closed market with a limited volume all s own, but a market like other markets, which interacts with markets for other inancial assets. The Treasury appears to view this market as closed, with a finite ossible size in spite of historical evidence to the contrary."

Again, Mr. Chairman, as an investment banker, I can tell you those words are the ruth.

The Senator from Alaska is on solid ground when he questions the validity of the Treasury Department's estimates of forgone revenues. Since I have never seen a redible explanation of how such estimates are reached, I must conclude that they re based on faulty assumptions, one of which is that if tax-exempt bonds were eliminated, investors would shift their funds to fully taxable issues. Clearly, this is ot the case.

Further, I have no reason to believe that the Treasury considers the indirect tax enefits which flow from the increased economic activity financed by a tax-exempt ond issue. This Subcommittee is familiar with the well-recognized multiplier effect f the profits earned and wages paid during the construction of new projects and of he additional revenues generated by taxes on financing and operations of facilities, s well as the enhanced local tax base.

Fifty years ago, Mr. Chairman, hydros supplied a third of America's electricity. Today the figure is no more than 13 percent and a good deal of that comes from torage facilities at large hydro plants.

At the request of President Carter, the Army Corps of Engineers in 1977 counted nd evaluated all the dams in the United States. Of the 49,500 dams the Corps found, less than 8 percent produced power. The rest were used for flood control, navigation, irrigation or water supply.

In another study, the Federal Power Commission found that no fewer than 770 hydro plants had been abandoned since 1940. The reason is obvious: Fueled by cheap oil, large steam-driven generators cranked out millions of kilowatts of electricity. The smaller, older hydros simply could not compete and were closed down by the hundreds.

The Middle East oil embargo of 1974 and frequent increases in petroleum prices by the OPEC cartel has caused a rethinking of national policy toward hydros. The Corps of Engineers estimates that the installation of additional generating capacity at existing dam sites could add to the nation's power pool about 54.6 million kilowatts, the equivalent of 85 good-sized nuclear plants. Almost half that power could come from small, undeveloped dams with capacities of 5,000 kilowatts, while the rest would come from installing more powerful and more efficient equipment at dams already producing power.

The advantages of hydro over other power generation methods are clear: It is renewable, unlike oil, coal or uranium. It is non-polluting and available throughout most of the country. Most hydro systems have two or three times the expected life of a conventional thermal plant, have lower operating costs and offer high efficiency—up to 94 percent.

In its report to the President, the Corps of Engineers concluded that "none of the identifiable constraints to the development of hydroelectric power at existing dams are insurmountable and the national potential is of such significance as to warrant the rapid selection and development of small scale hydro demonstration projects."

Senator Gravel has already explained that his legislation is designed to eliminate from Section 103(b) of the Internal Revenue Code of 1964 the so-called public-use test and the "two-county" rule which work to effectively deny the use of tax-exempt bonds for the development of hydropower.

It is important, Mr. Chairman, that the Congress address this matter from the standpoint of the contribution it can make toward the national goal of independence from foreign energy sources.

The Congress is completing work on an $88 billion bill which is designed to increase the production of synthetic fuels by the equivalent of at least half a million barrels of crude oil a day by 1987 and by the equivalent of 2 million barrels a day by 1992. That measure provides for a broad range of government subsidies in the form of purchase agreements, price guarantees and loan guarantees for up to 75 percent of the project costs.

The Senate Energy Committee, by a vote of 17 to 1, has reported S. 2470 which authorizes $3.6 billion in grants to encourage specified utilities to convert from oil or gas to coal as a primary energy source. The bill is designed to reduce the use of petroleum and natural gas by at least a million barrels a day within a decade.

Dozens of other measures are pending in the Congress, all designed to lessen this nation's dependence on foreign sources for our energy requirements.

In view of that congressional willingness to commit billions of dollars to energy independence, it seems ironic that there should be any reluctance to proceed with the development of a resource as plentiful and as available as hydropower.

Mr. Chairman, as a taxpayer I can well understand—indeed, I applaud—the current efforts in the Congress to achieve a balanced budget and to reduce unnecessary federal spending. Further, I readily acknowledge that a considerable portion of the municipal finance work of E. F. Hutton is in the field of tax-exempt issues. I could not, in good conscience, come before you this afternoon and ask your support of a bill that I felt was not in the nation's best interest.

The use of tax-exempt financing for a broad spectrum of public purposes has served America well. It has promoted industrial development, created jobs, rebuilt neighborhoods, provided affordable housing, curbed pollution and accomplished a significant number of other worthwhile public purposes.

It is true that because of the tax-exempt status of these bonds, there has been what amounts to a federal subsidy. That's the way the Congress intended it. States and localities which have issued the bonds have benefited from their proceeds in a manner, I suggest, that is more efficient, cost-effective and workable than federal subsidy programs administered by a massive and often unresponsive Washington bureaucracy.

In short, Mr. Chairman, I believe that passage of S. 2766 would not only make a significant contribution to solution of the nation's energy problem but would do so in a way that is completely compatible with the expressed intent of the Congress.

I will be pleased to respond to any questions members of the Subcommittee may have.

Senator **Gravel**. Mr. Hathaway to testify. That is S. 2547.

STATEMENT OF WILLIAM D. HATHAWAY, PEPSICO, INC., ACCOMPANIED BY ERNEST CHRISTIAN, JR.

Mr. **Hathaway**. Thank you very much, Mr. Chairman.

I am appearing this afternoon on behalf of Pepsico Co., Inc. in support of S. 2547, which would clarify the law that the costs of complying with the State antidisposable beverage container law can, like other solid waste disposal and pollution control facilities, be financed by tax-exempt industrial development bonds.

I am accompanied by my cocounsel, Mr. Ernest Christian, also of the firm of Patton, Boggs & Blow.

Mr. Chairman, 13 States, including Michigan, where Pepsico has a large bottling facility, have already adopted antidisposable beverage container laws. In general these laws ban the sale of beverages in cans with pull tabs and require bottlers to collect and dispose of all empty cans and bottles which consumers return to dealers in exchange for refund of their deposit.

One result has been to cause bottlers to convert their operations from the use of lightweight, nonreturnable, nonrefillable bottles to the use of heavy, more expensive refillable bottles. The initial cost of this conversion in operations, including the initial supply of returnable bottles and associated facilities plus equipment to crush and bale the cans, are very large.

In Pepsico's case in Michigan, for example, the cost is about $54 million. But that is only the initial cost. The continuing ongoing cost over the years, of course, will amount to much more. These are governmentally mandated costs for the purpose of solid waste disposal and pollution control. These costs do not increase the bottler's productivity or his output.

Where government imposes on private companies extraordinary osts to achieve a public purpose such as solid waste disposal, it is ppropriate and the Congress has deemed it so to allow these costs o be financed with industrial development bonds. Keep in mind hat the bottler would still bear the burden of these government-nandated costs.

Industrial development bonds would merely reduce the interest xpense in financing the initial capital outlays. In Pepsico's case, Detroit and several cities served by Pepsico's Michigan plant adopted bond resolutions to permit those government-mandated costs to be financed with tax exempt industrial development bonds under the provisions of present law related to solid waste disposal facilities.

It has, however, not been possible to issue those bonds. That is because of the refusal of the Internal Revenue Service to rule that the bonds are tax exempt. That adverse interpretation apparently relates primarily to the fact that in lieu of collecting the empty bottles, crushing them and making new bottles out of the waste glass, Pepsico is converted to refillable bottles which can, when collected, be washed, sterilized, and reused for a limited period of time.

The IRS apparently considers these bottles to have a value to Pepsico and therefore not to be solid waste, despite the fact that under present tax law and under the Solid Waste Disposal Act, empty beverage bottles clearly are solid waste.

Contrary to the position of the Internal Revenue Service, we believe that the policy of present law, if not the letter of present law, fully justifies allowing industrial development bond financing of facilities to comply with an antidisposable beverage container law.

S. 2547 is, in many respects, more narrowly drawn than comparable provisions of the present law. The amendment would not allow industrial development bond financing for replacement facilities or for ongoing business costs. Only the initial costs of facilities required at or about the time of the enactment of the antidisposable beverage container law would be covered.

Also, unlike present law, the amendment would apply only to costs which are mandated by law. For the same reasons, the revenue costs of S. 2547 could never be large, nor could the total amount of bonds issued pursuant to S. 2547 ever be significant enough to have any material effect on the bond market or on Treasury's borrowing costs.

Even if all the States in the Union adopted antidisposable laws, a very unlikely event, total eligible investments would be limited to the narrow category of the one-time cost required to be made at or about the time of enactment of each State's law.

The main point is that S. 2547 applies to government-mandated costs imposed to achieve the public purpose of solid waste disposal and pollution control. It is sound tax policy to allow these private costs to be financed with industrial development bonds.

Mr. Chairman, I would hope that the longer statement will be made a part of the record. I would like permission just to add a couple of points. The Treasury in its statement makes the point that since the Federal Government doesn't have any control over what the State may mandate or not mandate, that we shouldn't go along with this.

This is true with respect to pollution facilities. The State law can mandate certain pollution facilities be established, and as a result of that, under the law as it stands today, IDB treatment would be available. The Treasury also makes the point in opposition to the bill or the amendment that this is retroactive; but the Treasury by its own regulations provided the same kind of treatment to pollution facilities that were in existence at the time that the section that we would like to amend, the solid waste disposal section, was enacted into law.

Senator GRAVEL. I believe you make a very strong case.

Mr. HATHAWAY. Thank you very much.

Senator GRAVEL. Thank you very much. Thank you, Mr. Christian.

[The prepared statement of Mr. Hathaway follows:]

STATEMENT
OF
WILLIAM D. HATHAWAY
ON BEHALF
OF
PEPSICO, INC.
BEFORE THE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

JUNE 24, 1980

S. 2547

Summary Of Statement

1. PepsiCo, Inc., the second largest bottler of soft drinks, strongly supports S. 2547.
2. S. 2547 would make clear that the costs of complying with a state or Federal antidisposal beverage container law may, like other solid waste and pollution control facilities under present law, be financed with tax-exempt industrial development bonds.
3. The costs of compliance with these antidisposable beverage container laws are large and do not increase the bottlers' output or productivity.
4. Financing of those governmentally mandated costs, imposed on private companies to achieve a public purpose, is an appropriate use of industrial development bond financing.
5. S. 2547 is narrowly drawn. Only those costs directly attributable to complying with the antidisposable beverage container law would be eligible, and even those costs would not be eligible unless incurred at or about the time of the enactment of the antidisposable law. The costs of replacing such facilities and other ongoing business costs, even if associated with compliance with law, would not be eligible. In this respect, S. 2547 is more restrictive than the provisions of present law.
6. The revenue costs of S. 2547 could never be large; nor could the total amount of bonds issued pursuant to S. 2547 ever be significant enough to have any material effect on the bond market or on Treasury's borrowing costs. Even if all states adopted antidisposable laws -- a very unlikely event -- total eligible investment would be limited to the narrow category of one-time costs required to be made at or about the time of enactment of each state's law.

STATEMENT
OF
WILLIAM D. HATHAWAY
ON BEHALF
OF
PEPSICO, INC.
BEFORE THE
COMMITTEE ON FINANCE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

JUNE 24, 1980

S. 2547

Thank you Mr. Chairman. I am William D. Hathaway. I am appearing today as special counsel for PepsiCo, Inc., in support of S. 2547 which would clarify that tax-exempt industrial development bonds can be used to finance facilities necessary to comply with a state or Federal antidisposal beverage container law. I am accompanied by my co-counsel, Mr. Ernest S. Christian, Jr., also of the law firm of Patton, Boggs & Blow.

PepsiCo, Inc., the second largest soft drink company in the U. S., strongly supports S. 2547. In our view, this legislation is not an expansion of present law as concerns industrial development bonds. Instead, we think it is merely a necessary and appropriate clarification of provisions in present law which allow tax-exempt industrial development bond financing of solid waste disposal facilities. Under present law, such bonds may also be issued to finance pollution control facilities.

S. 2547 is directed to the problem presented when governments, Federal or state, impose on private companies the costs of achieving a public purpose. The private sector ought not be required to bear totally these governmentally mandated costs. The public ought, at least to some extent, bear part of the costs of achieving the intended public purpose -- in this case environmental protection and solid waste disposal.

Thirteen states, plus several local governments, have adopted antidisposal beverage container laws of one form or another. Among these are Delaware, Hawaii, Michigan, Minnesota Oregon and Virginia. Such laws are currently under active consideration in six local jurisdictions in New York State, and by the states of Louisiana, New Jersey, Pennsylvania and Massachusetts.

TABLE I

Current Statewide Beverage Container Laws

State	Type Of Law	Effective Date
California	Bans pull-tabs	January 1, 1979
Connecticut	5¢ deposit - 1¢ handling fee - bans pull-tabs	January 1, 1980
Delaware	5¢ deposit - bans pull-tabs and nonbiodegradable can holders	1 year after passage of similar legislation by Pennsylvania and Maryland
Hawaii	Bans pull-tabs	January 1, 1979
Iowa	5¢ deposit - 1¢ handling fee - bans pull-tabs	July 1, 1979
Maine	5¢ deposit - labeling requirement - bans pull-tabs and nonbiodegradable can holders	January 1, 1978
Massachusetts	Bans pull-tabs	June 1, 1979
Michigan	10¢ deposit - labeling requirement - bans pull-tabs	December 3, 1978
Minnesota	Bans pull-tabs	January 1, 1977
Oregon	5¢ deposit - labeling requirement - bans pull-tabs and nonbiodegradable can holders	October 1, 1972
South Carolina	Bans pull-tabs	May 5, 1978
State	Type Of Law	Effective Date
Vermont	5¢ deposit - labeling requirement - bans pull-tabs and nonbiodegradable can holders	July 1, 1975
Virginia	Bans pull-tabs	January 1, 1979

TABLE II

Current Local Beverage Container Laws

County	Type Of Law	Effective Date
Marin County, California	5¢ deposit	Effective date delayed pending approval by a majority of cities within the county
Montgomery County, Maryland	Pull-tab ban 5¢ deposit	January 1, 1978 October 1, 1980
Loudon County Virginia	5¢ deposit/pull-tab ban (carbonated soft drinks only)	1978
Fairfax County, Virginia	5¢ deposit/pull-tab ban (carbonated soft drinks only)	1977

Antidisposable beverage container laws generally are of two types. Some prohibit by law the sale of beverages in flip-top or pull-tab cans, and thus require the use of beverage cans with nondetachable openings. Other such laws, designed to encourage consumers to return empty bottles and cans, require deposits on all beverage containers. These laws also require bottlers to collect and dispose of the bottles and cans which are returned. Typically, antidisposable beverage container laws contain all of these features.

The beverage container law in Michigan, with which PepsiCo has recently had substantial experience, is a good example of a antidisposable beverage container law. This Michigan experience also provides a good illustration of the large amounts of governmentally mandated costs which these laws impose on bottlers. First, the Michigan law prohibits the sale of beverages in flip-top cans. Thus, PepsiCo has had to purchase and install new machinery to manufacture and affix to cans tops with nondetachable openings. Second, PepsiCo is required to collect and dispose of all empty bottles and cans which consumers return to the retailer in order to obtain a refund of the 10 cent deposit required by law. Consequently, PepsiCo has had to incur the additional costs of collecting these empty containers, and has had to purchase new machinery to crush and bale the empty cans which are solid waste that PepsiCo is required to dispose of. PepsiCo is also required to collect and dispose of all empty bottles. Disposal of solid waste in the form of glass bottles is, however, a much more expensive and difficult process than is the case with cans. Therefore, since PepsiCo is in any event required to collect and somehow dispose of the bottles, PepsiCo has, as a practical matter, been required to convert from the use of lightweight non-refillable bottles to the use of more expensive, heavy glass refillable bottles. That portion of these refillable bottles which are not cracked or broken may, by washing and sterilizing, be reconstituted into useable containers. These bottles, which PepsiCo is required by law to collect, are refilled and recycled back into the trade rather than being accumulated as solid waste which would be the case if PepsiCo continued to use and collect nonrefillable bottles. This was the intended and expected result of the beverage container law in Michigan.

However, in order to convert its operation to comply with the law, PepsiCo had to incur very substantial costs which did not increase the productivity or output of its bottling facility in Michigan. PepsiCo had to purchase the initial supply of expensive refillable bottles which alone cost about $20 million. PepsiCo also had to purchase additional trucks and carrying cases for heavy bottles, as well as machinery and equipment to process refillable bottles and warehouse facilities to store refillable bottles. All these facilities and equipment had been unnecessary prior to intervention of the Michigan antidisposable beverage container law with which PepsiCo was required to comply. In total, the capital costs directly associated with complying with the Michigan law amounted to about $54 million.

In recognition of the extraordinary nature of these governmentally mandated costs imposed on PepsiCo, the cities of Detroit, Dearborn, Dearborn Heights, Flint and Howell passed bond resolutions authorizing the issuance of tax-exempt bonds to assist in financing these large, new capital costs. These bonds would be tax-exempt industrial development bonds under section 103(b)(4)(E) of the Internal Revenue Code which expressly permits such bonds to finance solid waste disposal facilities. It has, however, not yet been possible to issue these bonds because the Internal Revenue Service refused to issue a ruling that these bonds would qualify as tax-exempt bonds for solid waste disposal facilities. The government has taken that position despite the fact that beverage containers are solid waste within the meaning of the Solid Waste Disposal Act, despite the fact that the legislative history of section 103(b)(4)(E) indicates that it was based upon the same principles as the Solid Waste Disposal Act, and despite the fact that the antidisposable beverage container law in Michigan was quite clearly enacted for the purpose of achieving environmental protection and solid waste disposal.

That tax-exempt bond financing is not available, absent the clarification provided by S. 2547, is an incongruous result. For example, had PepsiCo voluntarily gone out, collected discarded bottles, crushed the bottles, made new bottles out of the crushed glass, and recycled the bottles back into the trade at a profit, the facilities required to do that would qualify as solid waste disposal facilities under present law and would under present law be eligible for tax-exempt industrial development bond financing. On the other hand, according to the Internal Revenue Service, where PepsiCo is required by law to incur additional costs for solid waste disposal which accomplishes the same result as in the prior example, without increasing PepsiCo's output or profit, tax-exempt industrial development bond financing is not available.

Apart from its general hostility toward the use of tax-exempt bonds for either pollution control or solid waste disposal, the apparent basis for the Internal Revenue Service's adverse interpretation of present law is the so-called "fair market or other value" restriction which is solely an administrative creation found nowhere in the law enacted by Congress. Under this interpretation, empty bottles are not solid waste unless those bottles have "no market or other value at the place where . . . located." Where located in the backyards, garages, basements, etc., of consumers, empty beverage bottles, even refillable bottles, do not have any value since it would cost PepsiCo or any other bottler more to collect them than the bottles are worth. On the other hand, the Internal Revenue Service may mean that the bottles have a value because the consumer can get a refund of his 10 cent deposit if he takes the bottle back to the retailer; but this is patently an incorrect application of the IRS's own administratively created rule. The fact that a consumer can get back his deposit, his own 10 cents that he has already paid, does not mean that the empty bottle has a value in any real economic sense. The deposit and refund procedure is a mere formality (with no net economic effect) imposed by the requirements of state law. It would, of course, be possible for a person to go around and collect bottles, even on the roadside, and get the 10 cent refund of the deposit paid by someone else. But this would not be an economic endeavor because the true economic cost of collection would exceed the 10 cent refund value.

Alternatively, the IRS may mean that the empty refillable bottles have a value to PepsiCo where, after having been returned by the consumer, they are located at the retailer's store. But, again, this is an incorrect application of the IRS's own administratively created rule even assuming that rule has any validity. The empty bottles have no value to anyone other than PepsiCo. Even to PepsiCo, these bottles have no value until further processed to the point where they can be refilled. Moreover, any such restrictive IRS interpretation ignores three fundamental facts. First, PepsiCo paid the cost of the bottle to start with, so that any refillable bottle Pepsico recovers merely reduces the overall negative economic impact on PepsiCo of the beverage container law. Second, PepsiCo would not have incurred the additional costs associated with the use of refillable bottles but for the need to comply with the mandates of state law. Third, the additional costs of refillable bottles and all associated facilities do not increase PepsiCo's output or productivity.

Whether or not the costs of complying with an antidisposable beverage container law designed to achieve the purposes of environmental protection and solid waste disposal fit precisely into the provisions of present law, they are so closely related that the underlying policy of present law is equally applicable. In addition, allowance of tax-exempt industrial development bond financing of these beverage container facilities is justified by the fact that they are governmentally mandated.

Therefore, S. 2547 would amend present section 103 of the Code to provide a separate category for tax-exempt industrial development bonds for facilities to comply with an antidisposable beverage container law. This would leave undisturbed the present rules related to the more traditional categories of solid waste disposal facilities, including the IRS's "market or other value" rule which may have some utility in those other circumstances. Moreover, unlike the provision of present law related to other types of solid waste disposal facilities, S. 2547 would be limited to costs incurred to comply with state or Federal law.

The amendment that would be made by S. 2547 is narrowly and carefully drawn. Only those costs directly attributable to compliance, and only those costs incurred at or about the time of enactment of the beverage container law, would be eligible. Unlike bonds issued under the more liberal provisions of present law related to solid waste disposal, these bonds could not be used to finance replacement of existing facilities or to finance on-going, recurring costs after the initial impact of the conversion in operations required by the enactment of the beverage container law. In this respect, the amendment that would be made by S. 2547 is narrower and more restrictive than present law.

Under S. 2547, beverage container facilities would be eligible only if acquired, etc., after enactment of the beverage container law and within two years after the effective date of such law. Normally, beverage container laws have an effective date which is delayed a year or two after enactment in order to allow bottlers time in which to acquire or construct the additional facilities required to comply with the law. Thus, S. 2547 is confined to facilities made necessary solely by enactment of the beverage container law, and is, in fact, confined only to the initial facilities.

Because the facilities must be acquired at or about the time of the effective date of the beverage container law, tax-exempt bonds cannot be used for what is, in any realistic sense, an expansion of facilities. Any additional capacity which is added so close in time to enactment of the beverage container law represents an expansion that almost certainly would have occurred in any event. Tax-exempt financing would be available only for a portion of the additional facilities that would not have had to be included in the expansion but for the intervention of the beverage container law. The same rule applies to those who are new entrants in the bottling business at or about the time of the beverage container law. If the enactment of the beverage container law catches a new entrant right at the time he is putting in place his initial plant, tax-exempt bonds would be available only for those costs which would but for the beverage container law not have been incurred. Once, however, after two years, when the facilities required by law have become the norm for bottlers, no facilities, not even those required solely to comply with law, would be eligible for tax-exempt bond financing.

The specific type of facilities included would be limited to the initial supply of refillable bottles, and associated facilities for collecting, sorting, handling, storage, cleaning or processing those containers; all of which are costs attributable to the antidisposable beverage container law. Equipment directly associated with the requirement of non-detachable can tops would also be included in the eligible category.

Tax-exempt status would be available only for bonds issued after enactment of S. 2547. Proceeds of those bonds could be used to finance facilities already in use prior to enactment of S. 2547 only if the bond resolution was adopted by the state or local government before the construction, acquisition, etc., of such facilities.

The revenue loss to the Treasury associated with tax-exempt bonds authorized by S. 2547 could not be large; nor could there ever be a sufficiently large amount of such bonds to have any material effect on the bond market or on the Treasury's own borrowing costs. That is because of the narrow scope of S. 2547, whereby only facilities related to compliance with a beverage container law, and only those acquired at or about the time of enactment of the beverage container law, can be financed with these bonds. Thirteen states have adopted beverage container laws, but five of those laws became effective more than two years ago and would be outside the scope of S. 2547. Even if over the next decade all the remaining 37 states adopted such laws -- a very unlikely event -- the total eligible investment would, by definition, be limited to the narrower category of one-time costs required to be made at or about the time of enactment of each state law.

In conclusion, PepsiCo, Inc., strongly supports S. 2547. S. 2547 is an appropriate clarification of present law. S. 2547 provides for an appropriate use of tax-exempt industrial development bonds where mandated costs are concerned.

I thank the Committee for its attention.

Senator GRAVEL. Our next witness on S. 2784 is Mr. Robert Peabody, president of American Iron & Steel Institute.

Mr. Peabody, please proceed.

STATEMENT OF ROBERT B. PEABODY, PRESIDENT, AMERICAN IRON & STEEL INSTITUTE

Mr. PEABODY. Mr. Chairman, my name is Robert Peabody. I am president of the American Iron & Steel Institute, a trade association whose 63 domestic member companies account for more than 93 percent of the steel production in the United States.

I am appearing today to urge passage of S. 2784, a bill which changes the effective date for the applicability of energy investment tax credits to coke ovens. My brief remarks will summarize a more detailed statement which I have filed. I request that it be included in the record.

Senator GRAVEL. It will be included in the record as submitted.

Mr. PEABODY. I would like to make a correction on page 3 of that statement. The figure cited for the amount of investment tax credits that would accrue to eligible steel companies should be approximately $35.1 million rather than the $34 million cited. I would ask that the statement, as corrected, be included as part of the record.

The Energy Tax Act of 1978 as passed provided an additional 10-percent investment tax credit for "alternative energy property". Although such property includes equipment for converting an alternative substance, one other than oil or natural gas, into a synthetic liquid, gaseous or solid fuel, the words "other than coke or coke gas" were included in the conference report, thus making coke ovens ineligible for the "alternative energy property" investment tax credit.

To correct this inequity, Senator Heinz subsequently offered an amendment to the Crude Oil Windfall Profit Tax Act of 1980 to delete the exclusion of coke ovens. This amendment became the law. However, instead of making coke producing equipment eligible on the same basis as other equipment under the terms of the Energy Tax Act of 1978, that is, with an effective date of September 30, 1978, the effective date for coke ovens was made December 31, 1979, the effective date of the Crude Oil Windfall Profit Tax Act.

The effect of the December 31, 1979, date thus is to deny to domestic steel producers that placed into service new coke ovens or conducted overhauls or rebuilds of their coke-producing equipment between September 30, 1978, the effective date of the Energy Tax Act of 1978, and December 31, 1979, which was the effective date of the Crude Oil Windfall Profit Tax Act, the same treatment that is provided to other "alternative energy property"; that is, an additional 10-percent investment tax credit with an effective date of September 30, 1978.

Therefore, in order to fully correct the inequity that was originally placed against coke ovens as alternative energy property, the American Iron & Steel Institute urges you to approve S. 2784.

I would like to add one comment about the Treasury suggestion of a revenue loss of some $50 million in fiscal year 1981 and their suggestion of an additional $3 million fiscal year 1982 loss. I think the reality is that this is not at all likely to occur. There are two reasons. First, as is, unfortunately, too well-known, the operating rates of the domestic steel companies are such in the current recession that it is highly doubtful that there will be sufficient profitability to set against any investment tax credits.

But much more fundamentally, there are literally hundreds of millions of dollars of unused investment tax credits heretofore accumulated in the domestic steel industry. It is inconceivable, I think, to assume that they are going to be utilized in the next 2 fiscal years.

I think the net of it is, Senator, that coke ovens are fitted, so to speak, with the additional investment tax credit from December 31, 1979 forward. We are suggesting that the act be changed to permit it back to September 30, 1978, which was the date of the original Energy Tax Act.

Senator Gravel. Thank you very much, Mr. Peabody. I think you make a good case.

Mr. Peabody. Thank you, sir.

[The prepared statement of Mr. Peabody follows:]

STATEMENT OF

ROBERT B. PEABODY

PRESIDENT

AMERICAN IRON AND STEEL INSTITUTE

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

SENATE COMMITTEE ON FINANCE

JUNE 24, 1980

American Iron and Steel Institute

STATEMENT OF ROBERT B. PEABODY
PRESIDENT, AMERICAN IRON AND STEEL INSTITUTE
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE SENATE COMMITTEE ON FINANCE
JUNE 24, 1980

Mr. Chairman and members of the Subcommittee on Taxation and Debt Management, my name is Robert B. Peabody. I am President of the American Iron and Steel Institute (AISI), a trade association representing 63 domestic iron and steel producers which account for 93 percent of all domestic raw steel production. Thank you for the opportunity to express the views of the steel industry in favor of S. 2784, a bill which changes the effective date for the applicability of energy investment tax credits to coke ovens.

The Energy Tax Act of 1978 as passed provided an additional 10 percent investment tax credit for "alternative energy property." Although such property includes equipment for converting an alternate substance (one other than oil or natural gas) into a synthetic liquid, gaseous, or solid fuel, the words "other than coke or coke gas" were included in the conference report, thus making coke ovens ineligible for the "alternative energy property" investment tax credit. To correct this inequity, Senator Heinz subsequently offered an amendment to the Crude Oil Windfall Profit Tax Act of 1980 to delete the exclusion of coke ovens. The amendment became the law. However, instead of making coke-producing equipment eligible on the same basis as other equipment under the terms of the Energy Tax Act of 1978, i.e., with an effective date of September 30, 1978, the effective date for coke ovens was made December 31, 1979, the effective date of the Crude Oil Windfall Profit Tax Act.

The effect of the December 31, 1979 date thus is to deny to domestic steel producers that placed into service new coke ovens or conducted overhauls or rebuilds of their coke-producing equipment between September 30, 1978 (the effective date of the Energy Tax Act of 1978) and December 31, 1979 (the effective date of the Crude Oil Windfall Profit Tax Act) the same treatment that is provided to other "alternative energy property": an additional 10 percent investment tax credit with an effective date of September 30, 1978.

S. 2784 will correct this inequity.

Coke ovens are exactly the kind of investment the energy tax credit was designed to encourage, making possible shifts from oil and natural gas to other fuels. Coke ovens convert coal into coke, coke oven gas and other by-products, and are currently the only full scale production-tested coal gasifiers in commercial operation in the United States. We estimate that for each ton of coal charged, a BTU equivalent of approximately three barrels of crude oil is obtained in the form of coke and one barrel in the form of various by-products. These by-products have a variety of important uses as fuels or feedstocks. For example, coke oven gas is used in steel operations as a primary fuel displacing natural gas; tars and light oils are used as fuels or chemical feedstocks; and ammonia by-products are used as feedstocks in the production of agricultural fertilizers.

The steel industry presently derives about two-thirds of its energy needs from coal which is used to make coke to feed our blast furnaces, and coke oven gas, which is available as a fuel substitute in various steelmaking operations. However, with much of the steel industry's coke-making capacity in need of replacement, and due to the industry's limited ability to generate the capital needed to replace deteriorating equipment and invest in required environmental controls, this equipment is being retired faster than it is being replaced.

When sufficient domestic coke is not available, the steel industry must import coke from abroad. In 1979, we imported 4 million tons of coke, which represented a $340,000,000 contribution to our balance of payments deficit. In addition, four million barrels of oil were imported to make up for the coke oven gas and other by-products which would have been generated had the coke been produced domestically. This represented an additional $133,000,000 which was added to our trade deficit. The decline in domestic coke oven production capacity also has resulted in the loss of thousands of job opportunities for coke plant and coal mine workers, further adding to the nation's economic and social problems.

In summary, the inequity of excluding coke ovens from the definition of "alternative energy property" eligible for an additional 10 percent investment tax credit under the Energy Tax Act of 1978 was partially corrected by the "Coke Oven Amendment" to the Crude Oil Windfall Profit Tax Act of 1979. This amendment included coke ovens within the definition of "alternative energy property" under the Energy Tax Act of 1978 and, thus, they became eligible for the additional 10 percent Investment Tax Credit - but this became effective on December 31, 1979, the effective date for the Crude Oil Windfall Profit Tax Act.

In order to fully correct the inequity, we believe that the date applicable to the coke oven eligibility should be the date of eligibility for all "alternative energy property", i.e., September 30, 1978, the effective date of the Energy Tax Act.

The application of the investment tax credit to coke oven construction or rehabilitation for the period between September 30, 1978 and December 31, 1979 would total about $3~~4~~5,000,000 to those steel companies eligible. This would be helpful to the industry's capital formation problem at a time when, according to a recently released Treasury Department analysis (copy attached) done under the auspices of the Steel Tripartite Committee, the steel industry will have between a $1.3 and $1.5 billion shortfall annually (1978 $) in capital requirements over the five-year period from 1979 - 1983. Treasury is currently revising its analysis to reflect 1980 dollars, thereby increasing further this estimated gap between planned capital expenditures and industry capital availability.

Therefore in order to fully correct the inequity that was originally placed against coke ovens as alternative energy property and to provide some assistance to the capital formation problems of the steel industry, the American Iron and Steel Institute urges you to approve S. 2784.

Capital Availability: The Second Report to the Working Group on Modernization and Capital Formation

Submitted by: Government

Department of Treasury:
Brian Freeman
Lawrence Blume
Leslie Spero

Department of Commerce:
Al Brueckman
Jeffrey Mayer

Environmental Protection Agency:
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Industry

Donald F. Barnett
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Robert Jacobs
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John Sheehan
Legislative Director and Assistant to the President
United Steelworkers of America

Edmund Ayoub
Chief Economist and Assistant to the President
United Steelworkers of America

June, 1980

SUMMARY

To provide the Steel Tripartite Committee with the assessment of the U.S. steel industry requested by the Committee, the Working Group on Modernization and Capital Formation designated a joint staff to analyze the steel industry's "Orange Book". In its first report, the staff concluded that the industry's average annual capital requirements in 1979 and the next several years to modernize and meet environmental requirements on its existing capacity would be $4.6 - 4.9 billion (1978 $). In this second report, the staff presents its conclusions on the amount of capital available to the industry to meet those requirements, and on whether this modernization program will provide an adequate return on investment.

The staff's availability analysis examined the period 1979 - 1983, using 1978 data and profits, assumed shipments at the 90% capacity utilization rate used in the Orange Book, and certain other agreed-on assumptions concerning profits, external financing, dividends, and operating costs.

The staff concluded that the industry's planned capital uses under the modernization program would exceed its planned sources by an average of approximately $1 - 1.2 billion (1978 $) annually over the period 1979 - 1983.

Based on industry cost estimates accepted by the staff, it appears that a 25-year modernization investment would earn annual returns of approximately 12 1/2% on investment, and over 17% on the incremental investment above a base maintaining level.

These general conclusions carry several qualifications:

-- shipments in 1979 and probably in 1980 will be substantially less than assumed in the analysis; this would increase the annual shortfall for the five-year period by approximately $300 million.

-- the shortfall identified does not include the cost of funding that shortfall.

-- if the annual analysis was extended over a ten-year period, the average shortfall could be as small as $200 million, indicating an industry "hump" problem in the early years of the program.

-- the analysis examines the industry as a whole and uses average data, which may distort the actual problems or circumstances of specific firms.

-- the analysis assumed that inflation would impact revenues and costs equally.

The first two staff reports leave unresolved several issues which the Group or Committee may wish to pursue:

- the industry's financing of steel investment from non-steel operations
- the effect of "10-5-3" or other depreciation proposals on the industry
- future U.S. and world steel supply and demand and its implications on the future adequacy of steel supply in the U.S.
- Given U.S. labor and environmental costs, the future competitive position of the U.S. in steelmaking, both with and without the proposed modernization program
- the effect of technology advances on capital requirements

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ATTACHMENTS:

A. Total Return on Investment
B. Incremental Return on Investment
C. Sources and Uses: 1979-1988
D. Sources and Uses: Actual 1979 and Expected 1980 Shipments

INTRODUCTION

The Steel Tripartite Committee (the "Committee") established a Working Group on Modernization and Capital Formation (the "Group") to develop an assessment of the current status of the U.S. steel industry[1]/ in these areas. At the Group's organizational meeting on November 16, 1979, the Group decided initially to review the "Orange Book",[2]/ the industry's analysis of its capital needs and sources, rather than conducting its own de novo analysis. It adopted this approach as the most efficient way to define the issues and reach consensus within the Group. The Group, without concurring with the policy recommendations contained in the Orange Book, nevertheless used some of the Orange Book assumptions to examine the issues.

The 1977 Solomon Report stated that the industry's annual capital requirements in the next several years should average $4 billion (1977 $) and that with 1977 cash flows of no more than $2.2 billion there was a gap of $1.8 billion between the industry's cash flow and investment requirements.

For its analysis, the staff developed a three-step process. The first step would assess the Orange Book's treatment of industry's capital requirements; the second step would assess the capital available to the industry to meet the requirements identified in the first step; and the third step could analyze issues raised but not resolved in the first two steps and any other issues identified by the Group or Committee.

This is the second report of the joint industry, labor and government staff designated by the Group to analyze the Orange Book.

First Report

The staff presented its report on the first step (the "First Report") to the Group at the Group's March 14 meeting. The Orange Book identified the annual capital requirements of the industry as $7.0 billion. This aggregate amount was comprised of $.4 billion for debt reduction, $.1 billion for additional working capital, $.5 billion for expansion, $.8 billion for nonsteel, $.8 billion for environmental, and $4.4 billion for modernizing expanded capacity. The First Report covered only the capital

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1/ "Industry" as used throughout refers to U.S. companies for which a majority of revenues come from the manufacture of carbon, alloy and stainless steel products.

2/ Steel at the Crossroads: The American Steel Industry in the 1980s, American Iron and Steel Institute ("AISI"), January, 1980.

required for modernization and environmental expenditures and concluded that the annual capital expenditures required by the industry in the next several years would be $3.8 billion to $4.1 billion to modernize existing steel capacity and $.8 billion to retrofit that capacity to meet environmental[1] requirements. The $4.6 - 4.9 billion (1978$) staff estimate corresponds to a $4.0 (1977$) estimate in the Solomon Report. The First Report identified a number of issues on which the staff either could not reach complete agreement or did not analyze. The principal of these unresolved issues were:

-- future U.S. steel demand and supply, and the need, if any, for U.S. capacity expansion.

-- the appropriate industry debt and working capital levels.

-- the capital required for the industry's nonsteel operations.

-- the appropriate annual replacement rate for steel capacity.

These issues are important to the ultimate assessment of the industry's capital needs and any policy decisions which may be made by the Group or Committee.

Second Report

This Second Report reviews the Orange Book's treatment of the capital availability question, and the staff's assessment of the amount of capital which the industry should be able to raise to carry out the modernization program described in the Orange Book.

The Orange Book describes a twenty-five year modernization program. The First Report focused only on the modernization requirements in the next several years. This report will assess the capital available during a five-year period 1979-1983, and briefly comment on the subsequent five-year period. As in the Orange Book, 1978 dollars are used throughout.

The Orange Book's Scenario I assumed circumstances in which the industry could attain an average 90% capacity utilization over a twenty-five year period, although capacity utilization over the ten-year peiod 1969-1978 averaged only 85.0% (83.0% over five-year period 1974-1978). This Second Report projected year-to-year shipments and capital availability using 1978 as a data base, an assumption of a 90% capacity utilization, and industry estimates of the impact of the modernization program on operating costs.

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[1] As used throughout this report, "environmental requirements" includes safety and health requirements.

In reality, 1980 shipments are not expected to be the 102 million tons projected but are expected to be 85 million tons or less. Demand for steel is highly cyclical (with sizable peak to trough amplitudes), and, in the longer term, such cycles may even out. However, a downturn at the beginning of the modernization program can pose special problems by severely constraining capital availability and may suggest a need to reassess the amount of capacity which could or should be replaced in any modernization program.

Third Report

In this report and the First Report, the staff identified a number of issues on which it was unable to reach any conclusions. Some or all of these issues could be the subject of a third-stage analysis and report by the staff. The more important of these issues are identified in the last section of this report: UNRESOLVED ISSUES.

The first two reports adopted many assumptions for analytical purposes, with express reservations. How these assumptions are actually dealt with will significantly affect the size of the industry's shortfall.

METHODOLOGY

The First Report represented primarily the staff's analysis of the Orange Book's data, assumptions, methodology and conclusions regarding the industry's capital requirements. The staff did not undertake an independent examination of the industry's capital requirement because of the time and resources required, and because the basic information source for such analysis would have been the same as the Orange Book's - AISI's member companies.

The availability analysis in this Second Report, however, involves an independent assessment of the industry's capital sources and uses. The independent assessment was necessary for several reasons.

- First, the Orange Book does not contain annual estimates of capital sources available during its proposed modernization program, and does not identify a capital "shortfall" susceptible to analysis. The shortfall defined in the Orange Book is the difference between real capital recovery and capital expenditures under current tax rules, as compared to the proposed Capital Cost Recovery Act[1], if the $6.5 billion annual capital expenditures recommended in the Orange Book were made. The Orange Book does not define a total shortfall of capital required versus that available from all other sources. The Orange Book does discuss various other sources of capital, including debt and reinvested earnings, but there are no detailed estimates of annual profits, dividends, and reinvested earnings if the modernization program is undertaken.

- Second, unlike the Orange Book, the First Report did not include an estimate for expansion or non-steel expenditures and used a five-year period for the analysis rather the twenty-five-year period used in the Orange Book. Differences in the timing, amount and purpose of expenditures affect the capital available for subsequent expenditures. Therefore, a separate analysis based upon the adjusted needs of the First Report was necessary.

- Third, in the First Report, the staff relied to a great extent on the industry's estimates of its modernization needs and costs in the capital requirements analysis. In assessing the industry's financial resources, however, the staff, because of its collective expertise in this area, was better able to make independent assumptions and estimates.

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[1] The so-called "10-5-3" proposal, which would allow, after a five-year phase-in period, depreciation of buildings, equipment and vehicles over 10, 5 and 3 years, respectively, without regard to the useful lives of these assets.

ANALYSIS

To assess the capital available to the industry, the staff looked into the following key areas:

- Return on investment: Whether the cost savings from the modernization program would justify the proposed investment.
- Capital sources and uses: The key assumptions to be used to estimate available capital during the proposed modernization program.
- Cash flows from the industry's nonsteel operations: To what extent can they be considered as a source of capital for steel modernization expenditures.

RETURN ON INVESTMENT

To analyze the reasonableness of the proposed modernization program, the staff assumed that the industry would only modernize if the return on investment ("ROI") was favorable. To do this, two sets of assumptions were considered: one based on the total investment of $960 per finished ton and the other based on incremental investment beyond a base maintaining level. $960 is the average of the $920 to $1000 per ton replacement cost range identified in the First Report.

The total modernization program assumed a $960 per ton investment spread over four years to reflect the standard steel plant construction cycle. The cost savings from the investment were based on the Orange Book estimates, assuming the minimum sized efficient plants (three to four million tons for integrated plants). Current profitability plus the cost savings due to modernization represent the cash inflows from the investment. Depreciation was taken over a 12-year life on an accelerated basis[1] and coordinated with the investment tax credit to maximize tax reductions.

The analysis indicated a return on investment from the complete modernization program of 12.4% (Attachment A)[2]. The increased returns from modernization reflect the substantial changes in technology that have occurred in the steelmaking process in the last twenty-five years. Furthermore, substantial increases in energy costs in this energy-intensive industry, and the higher absolute and relative wages of the U.S. steel industry encourages companies to adopt new labor-and energy-saving technology as rapidly as possible.

The second analysis (Attachment B) examined the returns to the industry from pursuing incremental modernization beyond a base maintaining investment strategy. Based on industry estimates, the staff assumed that $560 per ton was required to maintain base operations, $400 per ton represented the incremental modernization investment, and the incremental investment results in 80% of the cost savings. The return on this incremental investment was 17.1% after tax. Furthermore, some individual modernization projects, such as coke ovens, blast furnaces, continuous casters, and plate and bar mills may have returns greater than 17%.

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[1] Double-declining balance changing to sum-of-the-years digits after 1.5 years.

[2] The 12.4% assumes 100% equity financing and no working capital. However, if one assumes additional investment of $100 per ton for working capital and that 30% of the total capital required is borrowed at 10%, the 12.4% ROI becomes a 14.1% discounted cash-flow return on equity investment.

Discussion

The additional return from modernization is primarily due to two factors. First, a decrease in man hours per ton from the current 9 hours to a projected 5 hours, reducing labor costs from the approximate 1978 level of $129 per ton, to a projected $71 per ton. Labor savings are critical because labor costs represent approximately one-third of total 1978 production costs. Second, an improvement in energy efficiency of approximately 35%. Energy savings are critical because of rapidly increasing energy costs.

The staff discussed cost savings estimates with some U.S. steel company executives and attempted to compare these estimates to those of Canadian producers. Based on these discussions, these cost savings appear to be attainable; however, there is some disagreement among industry experts as to their precise magnitude. This is one area which the Committee may wish to pursue.

The above ROI analyses do not take into account future market conditions which could increase or reduce the ROI from the rates suggested by the above estimates. For example, a downturn in steel sales could idle the modernized plant, reducing the ROI; an increase in real revenues would result in a higher ROI.

The analysis assumed a $960 per ton modernization investment and current average industry operating costs. If a particular plant has higher-than-average operating costs, or the modernization cost is less than $960 per ton, the ROI would be higher.

KEY ASSUMPTIONS

To determine the capital available to the industry, the staff divided the industry into steel and non-steel segments and analyzed the industry's sources and uses of funds in each of these two segments for each year, 1979 - 1983. 1/ The analyses used 1978 industry profits and taxes, adjusted for each year based on certain assumptions with respect to the following: shipments, profits, taxes, external financing, dividends, asset sales and working capital. The assumptions were, for the most part, agreed to by the staff. The following discussion includes any unresolved disagreements and concerns by staff members with these assumptions.

USES

CAPITAL EXPENDITURES

For this report, it was assumed that the average annual capital expenditures during the period would be $4.755 billion, the midpoint of the $4.6 - 4.9 billion range identified in the First Report: $.8 billion to meet environmental requirements, and between $3.8 billion and $4.1 billion to modernize existing steel capacity. These expenditures were assumed to be phased-in, beginning with $4.678 billion in 1979 and increasing to $4.832 billion by 1983.

Discussion

The First Report did not identify a specific annual replacement rate necessary to preserve a modern, competitive steel industry, although a 4 percent rate was adopted as a construct to compute the annual modernization requirement. The $3.8 billion and $4.1 billion figures reflect the staff's use of a range for estimating the costs of replacing a ton of finished steel capacity. Finally, the figures identified in the First Report were based on 1978 capacity, and to the extent that that capacity has been reduced through the plant closings -- which, presumably, were the least efficient plants with the highest modernization costs -- the modernization requirements, would also be reduced. On the other hand, the Orange Book estimate of environmental expenditures, accepted in the First Report, does not include the possibly substantial capital expenditures necessary to meet solid waste disposal requirements, which were only recently issued by EPA.

1/ The basic sources of funds are profits, non-cash expenses (depreciation and deferred taxes), net borrowing, and sales of assets and equity. The uses of funds are net working capital, dividends, and capital expenditures. A "shortfall" results if planned uses exceed planned sources.

DIVIDENDS

The analysis assumed that dividends each year will be either the 1978 level for the industry, $536 million, or 35% of after-tax profits, whichever is greater. 67% of this amount was allocated to steel operations , and 33% to nonsteel operations.

Discussion

The industry staff believes that despite the industry's poor profitability, the industry has a duty to maintain a consistent and reasonable level of dividends. Steel shareholders tend to minimize risk and rely on dividends. Dividends for the industry have eroded steadily since 1974 and the industry believes it cannot penalize its shareholders any more than has already been the case.

The Treasury staff believes that this undertaking of a major modernization program would require that the industry's historical dividend payout ratio, approximately 45% of after-tax profits, be reduced. Furthermore, this relatively high payout has not enabled the industry to issue any substantial amounts of new equity. The low ratio of stock prices to book value within the industry reflects the market's reaction to the industry's low profit levels despite the high payout ratio. A reduction in dividends, at least by some of the less profitable companies, will help finance the modernization program, which should result in increased profitability and increased value for steel equites. From the stockholders' point of view, capital gains from an increase in stock value may be more desirable than the ordinary income of stock dividends.

WORKING CAPITAL

The analysis assumes that the industry would need $.1 billion in additional working capital for steel operations each year. This is the figure identified in the Orange Book.

Discussion

The industry's current assets in 1978 were $18 billion, which includes $2 billion in cash and marketable securities and inventories on a current value basis; current liabilities were $10 billion, leaving $10 billion in net working capital or roughly $100 per finished ton. The staff believes $.1 billion is a reasonable estimate of the incremental working capital needed, given the increased volume projected. However, if the long-term shipment levels assumed do not materialize, working capital could be reduced to fund modernization expenditures.

SOURCES

PROFITS

The Second Report assumes profits each year to be equal to the 1978 profit, adjusted for increased shipments, the effects of the capital expenditure, and additional interest, depreciation and tax expenses. Revenues and costs (other than depreciation) were assumed constant, i.e., the inflation rate would be the same for all costs and revenues. Depreciation expense was deflated to compensate for the decreased value of historical cost depreciation due to inflation.

ADDED VOLUME

Steel shipments were assumed at the levels projected in the Orange Book, which assumed 90% capacity utilization: 101 million tons in 1979, increasing by 1 million tons each year thereafter. Each additional shipped ton above 1978 levels was assumed to provide an $80 variable profit.

REDUCED OPERATING COSTS

The assumed cost reduction from modernization was $113 per finished ton. Cost reductions were phased in with a two-year lag, with 4% of the total operating cost savings occurring by 1981, 10% by 1982, and 16% by 1983.

Discussion

The 6% annual increases in cost savings after 1981 are greater than the 4% replacement rate used in the Orange Book since it was assumed that the most cost-effective projects would be done first.

As previously indicated, the cost reduction and operating profit estimates were provided by AISI based on the industry average. These figures may vary considerably between individual firms. The lack of cost reductions during the first two years is the primary reason for the large capital shortfall in those years.

INCREASED ENVIRONMENTAL COSTS

Operating costs increases were assumed to occur each year because of environmental requirements. Annual increases used were provided by AISI, based on a 1980 study being prepared for AISI by Arthur D. Little Inc. By 1983, additional operating costs over 1978 levels were estimated to be $690 million. These estimates do not include the possibly substantial additional operating costs associated with meeting solid waste disposal requirements.

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Discussion

The EPA representative on the staff advised that the AISI estimates were approximately the same as EPA's preliminary estimates and that EPA estimates should be forthcoming in August, 1980. The staff believes that if market conditions prevent the industry from passing on these additional operating costs through higher prices, these costs, together with the higher U.S. labor costs, may result in a gradual shift of carbon steel production to less developed countries which impose less strict environmental standards; and such a loss of comparative advantage will have an impact on the industry's future capacity and capital requirements.

TAXES

The analysis assumes an effective Federal and State increased tax rate for the industry of 32%. The assumption was based on an effective industry tax rate in 1978 of 34%, reduced by the 2% reduction in the Federal corporate tax rate for years beginning after January 1, 1979. The analysis also assumed a Federal investment tax credit of 10% of 90% of capital expenditures. The credit is available only for equipment, which the analysis assumed to be 90% of the modernization expenditures.

Discussion

The analysis was made on an actual tax basis and then converted to book basis. The results indicate that, other than a minimum tax liability of approximately $50 million per year, the industry's steel segment will pay no Federal taxes during the first five years of the modernization program.

BORROWINGS

The analysis assumed new borrowings at a rate of 49.5% of new equity (stock sales and reinvested steel earnings). This was the approximate debt/equity ratio of the industry at the end of 1978. It was assumed that new debt would be issued at a 9% interest rate, a composite corporate and tax-exempt rate based on 1978 interest rates and reflecting the relatively high level of pollution control financing by some of the larger integrated companies.

Also included as a source was an additional $300 million, an estimate of the amount of unexpended proceeds from pollution control debt issued prior to 1979.

Discussion

Because of low interest/earnings coverage and the cyclical nature of the industry, this could be viewed as a high level of debt. Nevertheless, it is believed that the industry can maintain this level during the early years of the modernization program. This debt level need not be permanent and could be reduced with the additional profits in the later years of the modernization program.

The industry staff argued that current debt ratios would be difficult to maintain unless there were a much higher degree of certainty introduced into the economy in general and the steel market specifically. High debt ratios are extremely risky for an industry with low profit rates -- such as is the case with steel. Even assuming 90% utilization is maintained, profit rates for the industry as a whole will not improve significantly during the initial years of the industry's modernization program. If 90% utilization is not maintained, profit rates in some years will be quite low.

ASSET SALES

$.1 billion per year was assumed to be available from the after-tax proceeds from the scrapping or sale of excess industry property. $81 million was allocated to steel operations.

Discussion

The estimate is based on historical data from the firms' annual reports and does not include sales of profitable non-steel operations.

PROJECT AND LEASE FINANCING

$.1 billion per year was included as an estimate of the additional financing for raw materials available through leasing, projec. financing and long-term guaranteed purchase contracts.

Discussion

Approximately $500 million of the annual capital expenditures identified is for raw materials development. The staff believes that at least $.1 billion of this could be financed through off-balance sheet financing.

Industry staff noted that approximately 20% of current financing is off-balance sheet and argued that additional use of this source is severely limited especially since use of off-balance sheet financing constrains on-balance sheet financing. The industry staff notes that sales of raw material properties with a guaranteed (take or pay) raw material buy-back provision are usually economically unsound -- steel companies assume all the risk, and sacrifice long term profits for current cash and the uncertainty associated with any capital investment. However, assuming conditions which reduce market uncertainty during the modernization program, the industry would agree that approximately $.1 billion per year could be available from this source.

NEW EQUITY

Stock sales were assumed to be $.1 billion annually. $67 million was allocated to steel operations, and $33 million to non-steel operations.

Discussion

The $.1 billion estimate is roughly equivalent to the new stock issued by the industry in recent years, chiefly through dividend reinvestment and employee stock purchase plans. The last major equity sale by a steel company in the market was a $71.3 million issue of common stock by Inland Steel in 1976. The modernization program should increase industry profits and make industry stock issues more attractive, so that new equity should become a much larger source of capital during the modernization program. However, at the current time, few companies can issue new equity and the small amount assumed reflects this reality.

NON-STEEL CASH FLOW

The First Report analyzed only the capital required to modernize the industry's steel operations.

For this analysis, the industry's steel and non-steel operations were analyzed separately. Cash from steel operations, and from non-steel operations in excess of that needed to maintain existing operations, was considered an "available" source of capital for steel operations.

Based on an AISI special survey of 12 member companies covering the years 1975 - 1978, it was assumed that 33% of the industry's gross income and dividends, and 19% of its depreciation, investment tax credits and interest expense was attributable to non-steel operations, and annual capital expenditures of $.5 billion would be necessary to maintain these operations assuming no expansion. The analysis of non-steel sources indicated that an average of approximately $400 million in non-steel cash could be available from non-steel sources for capital expenditures each year during the 1979 - 1984 period. This $400 million includes $250 million in non-steel reinvested earnings, and an additional $125 million nonsteel debt (assuming an unchanged debt/equity ratio) and $33 million in stock sales -- both made possible by the non-steel earnings.

The Treasury staff's view was that $400 million should be considered available for steel capital expenditures. The industry staff's view was that, given returns in steel equivalent to non-steel, possibly $200 million could be made available for steel.

Discussion

In developing the First Report, there was disagreement among the staff over whether non-steel expenditures should be included. Because of the Group's primary concern with steel plant modernization, non-steel expenditures were excluded.

The Treasury staff's view is that since the Group is attempting to assess whether the industry has sufficient financial resources of its own any capital "available" to the industry should be considered, regardless of the source. Therefore, any cash from non-steel in excess of that necessary to maintain those operations would be available for the modernization program. Whether these funds will be spent to modernize steelmaking facilities, expand steel-related operations to process steel made by itself or others, or diversify, is a decision to be made by each individual company, project-by-project, based on the relative investment returns available to that company. Any diversion of non-steel cash flows need only be temporary - to enable the industry to fund any capital shortfall in the early years of the modernization program; in later years, the large cost reductions identified by the industry in the ROI analysis will eliminate the need for non-steel cash. If, as the industry has indicated, as much as one-half of these "non-steel" operations are dependent on steel operations, some diversion must occur merely to preserve the non-steel profits.

Treasury staff also noted that the staff's separate analyses of steel and non-steel operations may understate and perhaps mischaracterize the excess non-steel cash flows, since tax losses from steel operations in the early years of the modernization program would be available to shelter non-steel projects.

Industry staff disagreed with splitting steel from non-steel in the First Report. Given this division, however, industry staff argued that it is unreasonable to expect the industry to divert funds from profitable non-steel operations to less profitable steel operations. The net effect of this would be to make the industry less profitable and thus doom the modernization program and insure greater cuts in steel operations. For some years non-steel cash flow has been supporting investment in steel in the amount of approximately $200 million per year, and this has permitted little expansion of non-steel activities. Unless conditions are forthcoming which improve rates of return for steel versus non-steel, and reduce the risk of investing in steel, the steel companies could not justify to their shareholders or employees continuation of such a policy.

Industry staff also noted that approximately one-half of the so-called non-steel activities are steel-related and include steel construction, fabrication, and steel service centers. The expansion of these steel-related "non-steel" activities is essential to the industry's modernization program. Thus, the industry staff believes the most that could be made available for steel from non-steel sources in a modernization program, even given ideal circumstances, would be $200 million per year. Assuming circumstances that reduce the risks of market volatility during the modernization program and provide rates of return for steel equivalent to those in non-steel, the industry staff agrees that possibly one-half of the "available" non-steel cash flow per year ($200 million) could be invested in steel.

SOURCES AND USES

Based on the foregoing assumptions, the staff's estimate of the industry's steel segment capital sources and uses for the 1979 - 1983 period is as follows.

Table 1

Sources and Uses for Steel Segment
($ Millions, 1978 $)

	1979	1980	1981	1982	1983	Average
Shipments	101	102	103	104	105	
Uses						
Capital Expenditures	4678	4717	4755	4794	4832	
Change in Working Capital	100	100	100	100	100	
Dividends	357	357	357	357	357	
Total	5135	5174	5212	5251	5289	5212
Sources						
Profit After Taxes	1021	862	978	1175	1418	
Non-cash Expenses	1654	1673	1876	2221	2543	
Net New Debt	383	308	365	462	583	
Use of Env. Borrowing		100	100	100		
Asset Sales	81	81	81	81	81	
Addition to Stock	67	67	67	67	67	
Off Balance Sheet	100	100	100	100	100	
Subtotal	3306	3191	3567	4206	4792	
Surplus from non-steel						
Treasury	387	398	407	413	426	
Industry	194	199	204	207	213	
Total						
With $400 Non-steel	3693	3589	3974	4619	5218	4219
With $200 Non-steel	3500	3390	3771	4413	5006	4016
Shortfall						
With $400 Non-steel	(1442)	(1585)	(1238)	(632)	(71)	(994)
With $200 Non-steel	(1635)	(1784)	(1441)	(838)	(284)	(1196)

Extending the analysis over a 10-year period (1979-1988) (Attachment C) indicates that the average annual shortfall could be as small as $200 million[1] and there would be no shortfall in the later years.[2] When viewed with the staff's incremental ROI analysis, this suggests two conclusions: substantial cost reductions will occur only with sustained modernization expenditures in excess of those required for base maintaining; and the industry must overcome a "hump" problem, i.e., obtain the additional capital in the early years to produce the cost savings necessary to continue the program.

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[1] This assumes existing environmental requirements. The industry's operating costs and capital requirements would increase if the goals in the Clean Air Act and Clean Water Act become requirements: based on a forthcoming A.D. Little Inc. study for AISI, the staff estimates that the industry's annual average shortfall over the 10-year period would increase by $350 million.

[2] The Orange Book's Scenario I assumed rates of modernization between the fifth and tenth years in excess of 4% per year. The staff assumed a constant 4% during this period. The Orange Book approach would mean larger capital requirements in the fifth through the tenth years than the staff approach and would thus lead to a larger "shortfall", but also a faster rate of return improvement. Both approaches would arrive at a competitive, profitable industry before the end of a 25-year modernization program.

CONCLUSIONS

The staff estimates that the industry would have had a capital "shortfall" averaging approximately $1 - 1.2 billion (1978 $) annually during the period 1979 - 1983 if it had undertaken the modernization program identified in the Orange Book and shipments were at the levels assumed in Table 1.[1]/

Based on cost savings estimates provided by the industry and accepted by the staff, it appears that the modernation program should, in the longer term, provide adequate returns on investment.

Several qualifications must be made with respect to these general conclusions.

The funding of any shortfall involves costs, regardless of the sources used. Assuming the shortfall were to cost the equivalent of a 10% interest rate per year, the shortfall range would be $1.25 to 1.5 billion annually.

This analysis looked at the industry as a single entity, using average or composite data which may not completely reflect the circumstances or problems of individual companies. Profit levels, management strategies, financing capabilities, modernization requirements, and degrees of diversification vary considerably among companies within the industry and even within the large integrated-producer segment of the industry.

Finally, this analysis assumed that a modernization program would begin in 1979, and that shipments would be 101 million tons in 1979, increasing 1 million tons each year until 1983. This did not happen. Shipments were 100 million tons in 1979 and are likely to be 85 million tons or less in 1980. If the 1979 and 1980 shipment projections were revised to reflect actual circumstances, the average unfunded shortfall would increase to $1.3 - $1.5 billion annually (see Attachment D), demonstrating the problem posed by cyclical downturns during the early years of any modernization program.

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[1]/ The 1977 Solomon Report identified a $1.8 billion (1977 $) "gap":

> "Assuming that the industry spends $2.5 billion per year on maintenance and replacement, $1 billion on pollution control projects, and $0.5 on additional modernization projects, its annual capital requirements should average $4.0 billion (in 1977 dollars) over the next several years. Given that 1977 cash flow is likely to be no higher than $2.2 billion, there is a $1.8 billion gap between industry cash flow and investment requirements."

UNRESOLVED ISSUES.

The staff believes that a separate complete study by the Group of the capital needs and sources of the industry is unnecessary at the present time. The Orange Book and the two staff reports to date should provide the Group with an adequate basis for the current assessment of the industry in the area of modernization and capital formation requested by the Committee.

The staff discussions in preparation of these reports brought to light several related issues which were never fully resolved or analyzed. Their resolution could substantially affect the capital needs and sources identified, and therefore may need to be addressed by the Group or Committee.

- Industry Profitability. Every company should and probably will invest where it believes it can, in the long run, obtain the highest returns. Available capital will flow to the most profitable companies and industries. Perhaps more important questions than the extent of the industry's capital shortfall are: whether the relative profits in steel in the long term justify additional investments; what management actions other than additional investment can or should be taken to increase those profits; and at what point, if any, will the lack of investment in domestic steelmaking present a problem which the government must address.
- The effect on the industry of the proposed Capital Cost Recovery Act or other liberalization of tax depreciation.
- Future U.S. and world steel demand and supply and their implications on the future adequacy of steel supply in the U.S.
- The future competitive position of the U.S. in steelmaking given U.S. labor and environmental costs.
- The effect of possible technology advances on estimated capital requirements.

ATTACHMENT A

CASH FLOW FOR MODERNIZING PLANT: CURRENT TAX LAW
(Constant 1978 $, Assuming No Inflation)

	1st Yr		2nd Yr		3rd Yr		4th Yr		5th Yr		6th Yr		7th—12th Yr		13th Yr		14th Yr		15th Yr		16th Yr		27th Yr		Total
	Out	In	Out	In	Out	In	Out	In	Out	In	Out	In	Out	In	Out	In	Out	In	Out	In	Out	In	Out	In	
Investment	200		260		300		200																		
Operating Cost Savings (Before tax)						40		80		121		121		121		121		121		121		121		121	2903
Revenue—Operating Cost* (before tax)						80		120		161		161		161		161		161		161		161		161	3903
Deprec. (17-yr write-off but used when possible)								0		147		148		94		64		42		5		-		-	960
Taxable Income						80		120		14		13		67		97		119		156		161		161	2943
Tax Due (45%)						36		54		6		6		30		44		54		70		72		72	1314
ITC (10% but used as soon as possible)						36		54		6		-		-		-		-		-		-		-	96
Cash Recovery - After tax						80		120		161		155		131		117		107		91		89		89	2685
Net Cash Flow	-200		-260		-300	80	-200	120		161		155		131		117		107		91		89		89	1725
Internal Rate of Return (after tax)																									12.4%

*Revenue—Cost includes 1978 industry margins of $40 per ton ($435 revenue — $395 costs) and the operating cost savings.

ATTACHMENT B

INCREMENTAL CASH FLOW FOR MODERNIZATION: CURRENT TAX LAW
(Constant 1978 $, Assuming No Inflation)

	1st Yr		2nd Yr		3rd Yr		4th Yr		5th Yr		6th Yr		7th–9th Yr		10th–12th Yr		13th Yr		14th Yr		15th–27th Yr		Total
	Out	In	Out	In	Out	In	Out	In	Out	In	Out	In	Out	In	Out	In	Out	In	Out	In	Out	In	
Investment	75		125		125		75																400
Incremental Cost Savings (Before tax)						32		64		97		97		97		97		97		97		97	2327
Deprec. (17-yr write-off but used when possible								6		97		97		39		22		11		7		-	400
Taxable Income						32		58		-		-		58		75		86		90		97	1927
Tax Due (45%)						14		26		-		-		26		34		39		41		44	1872
ITC (10% but used as soon as possible)						14		26		-		-		-		-		-		-		-	40
Cash Recovery-After tax						32		64		97		97		71		63		58		56		53	1495
Net Cash Flow	-75		-125		-125	32	-75	64		97		97		71		63		58		56		53	1095
Internal Rate of Return (after tax)																							17.1%

[*] It is assumed that $560/ton shipment (this excludes any retrofit environmental or non-steel expenditures) must be spent to maintain existing plants and existing revenue-operating cost gaps. Therefore, of the total $960/ton shipments required to revitalize the American steel plants, $400/ton shipments is the incremental investment needed to make possible the operating cost improvements noted.

Atta unt C

Sources and Uses for Steel Segment, 1979 to 1988: Assuming No Environmental Requirements Beyond Those Currently Mandated

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	Average
Shipments (90%)	101	102	103	104	105	106	107	108	109	110	
Uses											
Capital Expenditures	4678	4717	4755	4794	4832	4870	4209	4247	4286	4324	
Change in Working Cap.	100	100	100	100	100	100	100	100	100	100	
Dividends	357	357	357	357	357	357	357	500	725	1015	
Total	5135	5174	5212	5251	5289	5327	4666	4847	5111	5439	5145
Sources											
Profit After Taxes	1021	862	978	1175	1418	1643	1945	2265	2570	2875	
Non-cash Expenses	1654	1673	1876	2221	2543	2904	3375	3075	2830	2880	
Net New Debt	383	308	365	462	583	650	242	319	388	352	
Use of Env. Borrowing	-	100	100	100	-	-	-	-	-	-	
Asset Sales	81	81	81	81	81	81	81	81	81	81	
Addition to Stock	67	67	67	67	67	67					
Off Balance Sheet	100	100	100	100	100	-	-	-	-	-	
Subtotal	3306	3191	3567	4206	4792	5345	5643	5740	5869	6188	4785
Non-steel Sources											
Treasury	387	398	407	413	426	-	-	-	-	-	203
Industry	194	199	204	207	213	-	-	-	-	-	102
Total Sources (unfunded)											
Treasury	3693	3589	3974	4619	5218	5345	5643	5740	5869	6188	4988
Industry	3500	3390	3771	4413	5005	5345	5643	5740	5869	6188	4887
Shortfall (unfunded)											
Treasury	(1442)	(1585)	(1238)	(632)	(71)	18	977	913	758	749	(157)
Industry	(1635)	(1784)	(1441)	(838)	(284)	18	977	913	758	749	(258)

Attachment D

Sources and Uses for Steel Segment Only:
Below 90% Utilization 1979 and 1980, 90% Utilization Thereafter
($ millions, 1978 $)

	1979	1980	1981	1982	1983	Average
Shipments	100	85	103	104	105	
Uses						
Capital Expenditures	4678	4717	4755	4794	4832	
Change in Working Capital	100	100	100	100	100	
Dividends	357	357	357	357	357	
Total	5135	5174	5212	5251	5289	5212
Sources						
Profit After Taxes	981	185	994	1190	1433	
Non-cash Expenses	1615	1022	1891	2236	2557	
Net New Debt	364	-28	373	470	591	
Use of Env. Borrowing		100	100	100		
Asset Sales	81	81	81	81	81	
Addition to Stock	67	67	67	67	67	
Off Balance Sheet	100	100	100	100	100	
Subtotal	3208	1577	3606	4244	4829	3493
Surplus from non-steel						
Treasury	387	398	407	413	426	
Industry	194	199	204	207	213	
Total Sources (Unfunded)						
With $400 non-steel	3595	1975	4013	4657	5255	3899
With $200 non-steel	3402	1776	3810	4451	5042	3696
Shortfall (unfunded)						
With $400 non-steel	(1540)	(3199)	(1199)	(594)	(34)	(1313)
With $200 non-steel	(1733)	(3398)	(1402)	(800)	(247)	(1516)

Senator Gravel. Our next witness is Mr. Malcolm Lovell, president of the Rubber Manufacturers Association.

Mr. Lovell.

STATEMENT OF MALCOLM R. LOVELL, PRESIDENT, RUBBER MANUFACTURERS ASSOCIATION, ACCOMPANIED BY RAY VAN LEUVAN, MANAGER OF TAX COMPLIANCE, UNIROYAL INC., AND EDWARD MORGAN, COUNSEL

Mr. Lovell. Thank you, Senator.

I have with me Ray Van Leuvan of the Uniroyal Co., who is manager of tax compliance, and Mr. Ed Morgan of Alexander and Green, a law firm in New York.

If I may, Senator, I would like to submit my formal statement for the record.

Senator Gravel. It will be included in the record as submitted.

Mr. Lovell. I will try and be very brief.

Under present law and regulations, the tire manufacturing industry must pay an excise tax on the tires it sells and must remit that tax on a twice-monthly basis on sales made during the previous one-half month. The present excise tax payment requirements are inequitable and impose a hardship on the industry which is in poor financial condition.

Now, the reasons we say the present requirements are inequitable are, first, manufacturers are required to make tax payments significantly earlier than the time they receive the proceeds of the sales which triggered the obligation. This results in the industry's being in the position of having to finance on any given day an average of $200 million in excise tax payments already made to the Treasury but for which payment from customers has not been received.

It is, we believe, fundamentally inequitable that the tire industry must borrow money for the privilege of paying this excise tax. We are not suggesting any change in the excise tax. We are suggesting that we not have to borrow money in order to pay it.

The cost we are talking about here ranges from $17 million to $24 million a year.

Next, S. 2493, which would permit the payment of the entire excise tax 90 days after the month of sale, would provide much-needed relief to the industry. The legislation does not alter the rate of the tax or the total amount of the tax, and the industry is not seeking in any way a subsidy from the Federal Treasury.

Now, we appear before you at this time because the industry is in a depressed financial position. In the past year, one smaller company has declared bankruptcy and discontinued tire production, while several major companies have been forced to close several plants or reduce employment in other plants.

I would say that unemployment in the tire industry at this time is in the tens of thousands of people. The rate of return on investment in the tire industry is the lowest of any major industry in the United States, and this depressed condition of the industry is not likely to change over the foreseeable future.

It is not only related to the automobile industry; it is related to an overcapacity, and the fact that tires are better and lasting longer. It is a condition which we expect to continue for some time.

Finally, I would like to point out that in the Treasury submission, in their testimony, Mr. Halperin suggests that the cost to the Treasury is both $190 million in the first year and $17 million a year subsequently. I would like to point out that that is really not so; that the cost to the Treasury is the interest on approximately $200 million.

As I say, that is approximately $17 million to $24 million a year, depending on the actual interest rates.

Mr. Chairman, that concludes my testimony.

Senator GRAVEL. Thank you very much.

[The prepared statement of Mr. Lovell follows:]

Summary of Principal Points

Statement by
Malcolm R. Lovell, Jr. President
Rubber Manufacturers Association
June 24, 1980

A. Under present law and regulations, the tire manufacturing industry must pay an excise tax on the tires it sells, and must remit that tax on a twice monthly basis on sales during the previous one-half month. The present excise tax payment requirements are inequitable and impose a hardship on an industry which is in poor financial condition.

B. The present requirements for excise tax payments are inequitable.

1. The present system, which is based on the time of sale between the manufacturer and the distributor, fails to account for normal industry business practice. Under normal practice, the industry extends credit on average for 90 days to its customers.

2. Thus, manufacturers are required to make tax payments significantly earlier than the time they receive the proceeds of the sale which trigger the tax obligation.

3. This results in the industry being in the position of having to finance on any given day an average of $200,000,000 in excise tax payments already made to the Treasury but for which payment from customers has not been received. It is, we believe, fundamentally inequitable that the tire industry must borrow money for the "privilege" of paying this excise tax.

C. The tire industry is in a depressed financial position.

1. In the past year, one smaller company has declared bankruptcy and discontinued tire production, while several major companies have been forced to close several plants or reduce employment at other plants.

2. The rate of return on investment of the tire industry is the lowest of any major U.S. industry.

3. This depressed condition of the industry is not likely to change over any short period.

D. S. 2493, which would permit the payment of the tire excise tax 90 days after the month of sale, would provide much needed relief to the industry.

1. By bringing the tax payment schedule more in line with industry credit and payment practice, it would correct this serious inequity.

2. By relieving the industry of the obligation of financing the excise tax payment, it would free much needed financing to be applied to more productive uses.

3. The legislation does not alter the rate of tax, nor the total amount of tax to be realized by the government.

4. The industry is not seeking, nor does the legislation provide, any subsidy from the federal treasury.

E. We urge the prompt enactment of S. 2493.

STATEMENT BY
MALCOLM R. LOVELL, JR., PRESIDENT
RUBBER MANUFACTURERS ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE
JUNE 24, 1980

I am Malcolm R. Lovell, Jr, President of the Rubber Manufacturers Association, representing here today the United States tire manufacturing industry. Our members have tire manufacturing facilities in 24 states, and when office and sales facilities are considered, are in active business in all 50 states. I am grateful for the opportunity to appear before the Subcommittee today, in order to convey the unequivocal support of our industry for S. 2493. S. 2493 would not alter the amount of excise tax payable on tires and tubes, but it would at this particularly crucial time for the U. S. tire industry correct an inequity, by permitting the excise tax to be paid to the government more nearly at the same time as sales proceeds are received by the manufacturer from which the tax may be paid.

Under present law (Section 4071 of the Internal Revenue Code of 1954, as amended), there is imposed upon tire manufacturers at time of sale an excise tax at the rate of 10 cents per pound on new tires and inner tubes of the type used on highway vehicles, and 5 cents per pound on tread rubber and tires of the type used on nonhighway vehicles. Under regulations prescribed by the Treasury Department, if a taxpayer has incurred more than $2,000 of excise taxes in any month of the preceding calendar quarter, he most deposit such taxes for the following quarter (regardless of amount) on a semi-monthly basis. Deposits of manufacturers

best copy available

e taxes must be made on or before the 9th and the 24th days of the
, for the semi-monthly period ending nine days earlier. Treas.
§48.6302(b)-1(b)(2) (1970).

The excise tax payment schedule is presently based upon the
of sale (or constructive sale) by the manufacturer to a distributor.
the excise tax represents a portion of the overall sale proceeds,
ould be rational to expect the manufacturer to be required to turn
excise tax funds to the government promptly after their receipt by
manufacturer, but that is not what actually happens. By keying the
dence of tax to the time of sale, present law fails to take into
unt normal business credit terms or other timing differences between
time of sale and the time of receipt of payment. In effect, tire
ufacturers are not only required to pay one of the few manufacturers
ise taxes on a basic consumer product, (a tax, by the way, enacted as
temporary" measure in 1932), but they must also borrow money for the
vilege of paying the excise tax.

More specifically, competitive conditions require almost all
e manufacturers to extend credit terms to customers. Based upon prior
dustry studies, confirmed recently again upon consultation with our
mbers, most of the $878,000,000 of tire excise tax payments made to the
ternal Revenue Service in 1979 were made 90 days or more before any
covery of transaction proceeds from customers. It should be noted
at this information is based on average credit terms, and actual collec-
ons have recently been significantly slower in many instances (payments

deferred by Chrysler Corporation being just one illustration). As a consequence, the tire industry is for all practical purposes in the position on an average day of having to "advance" over $200,000,000 of excise tax payments to the federal government. "Advances" of this magnitude, impairing capital formation for productive purposes, are of serious concern to the tire industry, currently also beset by other substantial economic problems.

Congress did look at this area some years ago. In 1966, in order to eliminate a difference in excise tax payment dates between manufacturers selling through their own stores and manufacturers selling to independent dealers, Congress accelerated the excise tax payment dates in the former situation. Pub. L. No. 89-523, 80 Stat. 331 (1966). We submit that experience has shown this to have been an inequitable approach -- what should have been done was to set the excise tax payment date requirements for all tire manufacturers in a manner more consistent with the realities of when sale proceeds are received. The record shows that the average credit terms have not changed greatly over the years (see S. Rep. No. 1365, 89th Cong., 2nd Sess. (1966), reprinted in 1966-2 C.B. at 775-76), thus further justifying the reasonableness of the relief sought through S. 2493.

Apart from the equitable considerations, which we believe are sufficient in themselves to fully justify the deferral of the excise tax payment date for tires, tubes and tread rubber as embodied in S. 2493, this bill is particularly timely in view of the present depressed economic circumstances of the United States tire industry. These conditions e well documented and in the past year include the discontinuance tire production and bankruptcy of Mansfield Tire and Rubber Co., nouncement by Firestone Tire and Rubber Company of six plant closings d personnel layoffs of 8,800 workers, discontinuance of tire producon by Lee Tire & Rubber Co., the decision of Uniroyal, Inc. to close o plants and make accompanying layoffs, and layoffs of thousands of ditional workers by Goodyear Tire & Rubber Co., General Tire & Rubber . and Armstrong Rubber Co., among others. For those companies still ntinuing, earnings have been low, to the point where the tire industry s had the lowest rate of return on investment of any major industry the United States. Because of the urgent need to respond to rapidly anging tire technology, the depressed earnings conditions are not ikely to change fundamentally over any short period. Relief is needed w in the tire industry, and S. 2493 would provide it.

Under S. 2493, manufacturers would be permitted to pay the xcise tax on tires and tubes 90 days after the end of the month of sale. uch change would bring the excise tax payment schedule more nearly into alance with financial realities as has been explained. Please note that he tire industry is not here asking for repeal or reduction of the excise ax, even though that might also be advantageous, but merely seeks to orrect a financial inequity under the existing payment requirements. he tire industry here is also not seeking any subsidy from the federal reasury, but only to eliminate the inequitable burden of paying an excise ax to the government before receipt from customers of the funds with which to make payment. Based upon present interest rates, S. 2493 would result in a one-time revenue loss to the government (because of the nature of timing adjustments) of roughly $30 million. This would be of direct immediate benefit to each and every manufacturer in this distressed industry, in the process giving financial support to continuing employment levels in the industry. For all of these reasons, S. 2493 is sound legislation, and we urge its prompt enactment by the Congress.

Senator GRAVEL. Our next witness is Mr. Fred Gentile, vice president and comptroller, Brooklyn Union Gas.

Mr. Gentile.

STATEMENT OF FRED J. GENTILE, VICE PRESIDENT AND COMPTROLLER, BROOKLYN UNION GAS

Mr. GENTILE. Mr. Chairman, my name is Fred Gentile. I am vice president and Comptroller of the Brooklyn Union Gas Co. In that capacity, I am very pleased to have the opportunity today to present the views of Brooklyn Union Gas with respect to Senate bill 2660, legislation intended to clarify the definition of the term "local furnishing" contained in section 103(b)(4)(E) of the Internal Revenue Code of 1954.

Brooklyn Union fully supports and urges the enactment of Senate bill 2660. Briefly by way of background, Brooklyn Union furnishes and distributes natural gas at retail exclusively in three counties, all of which are within New York City. We serve approximately 4 million New York City residents, in addition to small commercial and industrial businesses.

The question here is the definition to be given to the word "local" contained in section 103(b)(4)(E). That section allows the issuance of tax-exempt bonds to finance the construction of facilities for the local furnishing of electric energy or gas.

Since 1968, the total local furnishing was interpreted by the U.S. Treasury Department to have the same meaning for both electric energy and gas. Essentially under the Treasury regulations, the term "local furnishing" was defined as a service area no greater than two contiguous counties. However, where the service area consisted of a city, the local furnishing requirement could not be satisfied if the city consisted of more than two counties.

The geographical size of the city or the county was not taken into account. Essentially, whether the local furnishing test could be satisfied in the case of a city was dependent solely upon the political structure of the city. If the city had more than two counties, such as the case with New York City, the test could not be met.

This interpretation distorted the basic notion of the word "local." In the Revenue Act of 1978, both Congress and I might add that the Treasury Department fully supported and concluded that "local" should not be defined in such a distorted manner, but

ther the term "local," if it means anything, should at least
clude a single city.

Unfortunately, the clarification appears to have been inadvert-
tly limited only to electric energy. Gas was forgotten. Senate bill
60 is intended to cure this oversight by simply extending the
arifying definition of local furnishing by the Revenue Act of 1978
the local furnishing of gas. Once again the term "local" will be
terpreted the same way for both electric energy and gas.

It is well known that the residents of New York City pay the
ghest gas and electric rates in the Nation, which rates are rapid-
escalating.

Mr. Chairman, the enactment of Senate bill 2660 would substan-
ally assist Brooklyn Union in its efforts to tap the potential of
ethane gas in the various landfills located in its service area.
rooklyn Union has for several years been interested in developing
its fullest extent the use of these landfills within New York City
a potential source of energy.

Studies made by Brooklyn Union show that one such landfill in
ew York City, once tapped, has the potential of producing enough
as to heat approximately 15,000 homes annually, and thereby
educe the need of imported oil by approximately 1,700 barrels a
ay.

Mr. Chairman, any benefit Brooklyn Union receives from Senate
ill 2660 is passed on to its consumers due to lower cost of financ-
ng reflected in rates.

In conclusion, Mr. Chairman, Brooklyn Union fully supports and
trongly urges the enactment of Senate bill 2660. With the addition
f just two words, the bill corrects what can be described as an
versight in a prior amendment. It also substantially advances our
ational energy goals.

Mr. Chairman, we request that our complete statement in sup-
ort of the enactment of Senate bill 2660 be entered into the
ecord.

That ends my discussion. Thank you.

Senator **Gravel**. Thank you very much.

It dovetails some of the work that I am doing myself, and so I
an assure you that your testimony is falling on good ears.

Mr. **Gentile**. I appreciate your understanding. Thank you.

Senator **Gravel**. Thank you, sir.

[The prepared statement of Mr. Gentile follows:]

SUMMARY OF ATTACHED STATEMENT OF THE BROOKLYN UNION GAS CO.

e S. 2660—Definition of "Local Furnishing" contained in section 103(b)(4)(E).

1. The Brooklyn Union Gas Company fully supports and urges the enactment of
enate Bill 2660, legislation intended to clarify the definition of the term "local
urnishing" under Section 103(b)(4)(E) of the Internal Revenue Code of 1954. Senate
ill 2660 simply corrects what appears to be no more than an inadvertent oversight
esulting from the clarifying amendment made to the definition of the term "local
urnishing" by the Revenue Act of 1978. That amendment simply forgot to include
as.

2. The subject of considerable interest to municipalities throughout the nation is
o capture and use the methane which is naturally produced in landfills.

Senate Bill 2660 would, among other things, provide assistance to Brooklyn Union
o develop the landfills within its service area (located entirely within New York
ity) as a potential source of additional gas, and thereby provide the opportunity to
urther reduce the nation's dependence on foreign oil.

STATEMENT OF THE BROOKLYN UNION GAS CO.

Re S. 2660—Definition of "Local Furnishing" contained in section 103(b)(4)(E).

Mr. Chairman and Members of the Subcommittee, my name is Fred J. Gentile. I am Vice-President and Comptroller of The Brooklyn Union Gas Company. In that capacity, I am very pleased to have the opportunity today to present the views of Brooklyn Union with respect to Senate Bill 2660, legislation intended to clarify the definition of the term "local furnishing" contained in Section 103(b)(4)(E) of the Internal Revenue Code of 1954, as amended.

Brooklyn Union fully supports and urges the enactment of Senate Bill 2660. Senate Bill 2660 corrects what appears to be no more than an inadvertent oversight resulting from a clarifying amendment made to the definition of the term "local furnishing" contained in Section 103(b)(4)(E) by the Revenue Act of 1978. In summary, the Revenue Act of 1978 amended the definition of the term "local furnishing" contained in Section 103(b)(4)(E) to include a service area no larger than one city and one contiguous county. However, the amendment was we believe inadvertently limited to electric energy, and simply forgot to include gas, given that the term "local furnishing" was clearly intended (and for the ten years prior to 1978, consistently interpreted by the Treasury department) to have the same meaning when referring to both the "local furnishing" of electric energy as well as gas. The effect of Senate Bill 2660 is simply to clarify and conform the definition of the term "local furnishing" contained in Section 103(b)(4)(E) in order that the term once again will have the same meaning when referring to both the local furnishing of electric energy as well as gas.

The Brooklyn Union Gas Company is a regulated public utility engaged in the local distribution and furnishing of natural gas at retail exclusively within certain portions of New York City. Brooklyn Union serves approximately 4 million New York City residents, almost all of whom are residential customers. Approximately 97 percent of its customers are residential customers, the balance are primarily small or modest commercial or industrial businesses. Its service area is a relatively small area, consisting of 187 square miles, which serves the Borough of Brooklyn, the Borough of Staten Island and a portion of the Borough of Queens, all of which are within New York City.

New York City's political structure consists of five Boroughs (Brooklyn, Staten Island, Queens, Bronx and Manhattan) each of which is a separate county. The Boroughs of Brooklyn, Staten Island and Queens are respectively Kings County, Richmond County and Queens county.

Senate Bill 2660 is of singular importance to Brooklyn Union and the 4 million residents it serves. It is well known that the residents of New York City pay the highest gas and electric rates in the nation, which rates are rapidly escalating. As a result, I would like to stress the particular timeliness of including gas within the clarifying amendment made to the definition of the term "local furnishing" by the Revenue Act of 1978. There can be no doubt that it is in the nation's best interest at this time to minimize its heavy dependence on foreign oil, and that every effort should be made at this time to develop all possible domestic sources of energy (including methane).

One very logical first step, and the subject of considerable interest to municipalities throughout the nation, is to capture and use the methane which is naturally produced in landfills. By a process of anaerobic decomposition, gas (composed primarily of methane and carbon dioxide) is produced in these landfills and, because it is lighter than air, now simply rises and escapes into the atmosphere. Brooklyn Union has for several years been interested in developing to its fullest extent the use of these landfills within New York City as a potential source of energy. Studies made by Brooklyn Union show that one such landfill in New York City, once tapped, has the potential of producing enough gas to heat up to approximately 15,000 homes annually and, thereby, reducing the need to import approximately 1,700 barrels of oil a day. In fact, we estimate that full development of the methane from the major landfill sites in Brooklyn Union's service area, could supply as much as 15 percent of our customers' current gas requirements.

Among other things, the enactment of Senate Bill 2620 would go a long way in assisting Brooklyn Union to develop fully the additional source of gas that these landfills can provide.

Section 103(b)(4)(E)

In general, under Section 103 of the Internal Revenue code of 1954, the interest on the obligations issued by a State or local government (or political subdivision thereof) is tax exempt. However, as a general rule, the interest on industrial development bonds is taxable and not tax exempt, except in certain limited circumstances where the proceeds of the industrial development bonds are used for certain specified exempt purposes. One of the specific exempt purposes relates to "facilities for the local furnishing of electric energy or gas."

As originally enacted in 1968, the phrase "facilities for the local furnishing of electric energy or gas" was not defined any place in Section 103 of the Code, although it was apparent from the words of the statute that the term was clearly intended to have the same meaning for purposes of both the "local furnishing" of electric energy and gas. Further, no definition or interpretation of the term "local furnishing" was contained in the various committee reports, the transcript of the floor debates or the statement of the conferees which accompanied the original enactment of Section 103(b)(4)(E).

Thus, as originally enacted, a question existed as to what constituted the "local furnishing of electric energy or gas" for purposes of Section 103(b)(4)(E).

The term "local furnishing" was first defined in the Treasury Regulations promulgated under Section 103(b)(4)(E). Consistent with the language of Section 103(b)(4)(E), the Regulations defined the term in the identical manner for purposes of both the local furnishing of electric energy as well as gas. Under the Treasury Regulations, in order to qualify as a facility for the "local furnishing of electric or gas", the facility could serve an area no larger than two contiguous counties. The geographical size of either county was not a factor to be taken into account. Treas. Regulation § 1.103-8(f)(2)(iii)(d) provided as follows:

"The term 'facilities for the local furnishing of electric energy or gas' means property which . . . is part of a system providing service to the general population of one or more communities or municipalities but in no event *more than two continguous counties (or a political equivalent)* whether or not such counties are located in one state". (Emphasis added.)

Further, the Regulations provided that the "no more than two contiguous counties" rule would apply to a city in the following manner:

"For purposes of this [Regulation], *a city which is not within, or does not consist of, one or more counties* (or a political equivalent) shall be treated as a county."

Thus, as interpreted by the Regulations, the "local furnishing" requirement was the same for both electric energy and gas and, in either case, could be satisfied if the service area consisted of one city (regardless of geographical size) only if the city was an independent political entity. On the other hand, where the service area included a city which consisted of more than two counties (such as New York City), the "local furnishing" requirement could not be satisfied for either electric energy or gas. Thus, under the "no more than two contiguous counties" rule, the "local furnishing" requirement could not be satisfied in certain cases even though the service area of the facilities consisted of a single city.

Under the Regulations, the "local furnishing" requirement thus was based in large part on the particular political structure or arrangements of a local jurisdiction and not on the geographical size of the area serviced by the facilities or the geographical size of the local jurisdiction. In effect, such an interpretation distorts completely the basic notion of the word "local". For example, cities such as Jacksonville (which consists of 766 square miles) and Oklahoma City (which consists of 636 square miles) could satisfy the "local furnishing" requirement,[1] while cities of a much smaller geographical size (such as New York City which consists of only 300 square miles) could not solely because they are not independent political entities.

The absurd effect of the interpretation of the term "local furnishing" contained in the Treasury Regulations was called to the attention of Congress and the Treasury Department in 1978. Both the Treasury Department and Congress agreed that the proper test for determining whether the "local furnishing" requirement is met where the service area consists of (or includes) a city should not depend on the particular political arrangements of the city. Rather, both believed that the "local furnishing" requirement should be applied in a fair and consistent manner with respect to all local jurisdictions regardless of their political structures. Thus, in a letter to Senator Moynihan, the Assistant Secretary for Tax Policy stated the Treasury's position as follows:

"(s)ince a city is a single government unit, even if it embraces more than one county, the requisite local character of the furnishing is as much met by the standard you propose as by the current two-county standard. For reasons of consistency in the treatment of local jurisdictions for purposes of the 'local furnishing' test, we therefore support your amendment."

Accordingly, as part of the Revenue Act of 1978, the definition of the term "local furnishing" was clarified to include a service area consisting of no more than one city and one contiguous county. However, the clarification appears to have been inadvertently limited only to the local furnishing of electric energy, and forgot to include the local furnishing of gas, even though the term "local furnishing" had always prior to that time been given the same interpretation by the Treasury Department for both electric energy and gas.

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[1] See Statement of Senator Moynihan, Congressional Record, May 6, 1980, when he introduced S. 2660.

Conclusion

Senate Bill 2660 is intended to cure what appears to be no more than an inadvertent oversight from the Revenue Act of 1978. In effect, Senate Bill 2660 simply extends the clarifying amendment made to the definition of "local furnishing" by the Revenue Act of 1978 to the local furnishing of gas. Further, for the reasons identified above, enactment of Senate Bill 2660 will provide Brooklyn Union with assistance to fully develop landfills located in its service area as a source of additional gas, consistent with the national objective of greater dependence on domestic sources of energy.

In conclusion, Mr. Chairman, Brooklyn Union fully supports and urges the enactment of Senate Bill 2660.

Thank you.

Senator **Gravel**. Mr. John Babson, Chairman, Executive and Steering Committee, Special Committee for U.S. Exports. Mr. Babson.

STATEMENT OF JOHN R. BABSON, CHAIRMAN, EXECUTIVE AND STEERING COMMITTEES, SPECIAL COMMITTEE FOR U.S. EXPORTS, ACCOMPANIED BY JAMES JACKSON, COUNSEL

Mr. **Babson**. Mr. Chairman, my name is John R. Babson. I am chairman of the executive and steering committees of the Special Committee for U.S. Exports and vice president of Ingersoll Rand.

My testimony is on behalf of the special committee.

With me is James Jackson, of Dawson, Riddell, Fox, Holroyd, and Wilson.

The special committee is a participating group of more than 1,200 business concerns and 80 supporting business associations whose operations and concerns are directed to the export of U.S. products. The special committee's major concerns are with the effect of the U.S. tax system on exports by U.S. businesses and the ability of those businesses to compete in foreign trade in view of the many tax advantages and incentives and direct and indirect subsidies provided to foreign competitors by their governments.

The concerns of the special committee are aptly set forth in the remarks of Ambassador Reubin Askew, U.S. Trade Representative, on June 10, 1980. I quote:

> There may have been a time when the United States of America could, without question and without challenge, dominate the world economy, but no more. Further, there may have been a time when we could simply assure in America that our high standard of living would grow higher and higher, but not any more. Finally, there may have been a time when we could afford in America merely to react to economic issues as they arose and address them separately and without regard to their crucial interrelationships, but no more.
>
> For several years, we have been faced with international trade deficits, declining productivity and inadequate capital formation. This has led to devaluation of the dollar, inflation, restrictive monetary controls, recession and deficit spending. Looking at our international trade position over the last decade as a major factor, our present economic condition is the expected result.
>
> There has been a great deal of discussion of the need for increasing exports over the last several years. It is widely recognized that there are a number of areas where encouragement and incentives for United States exports will produce results. However, the preponderance of governmental action has reduced, not increased exports. Examples of governmental action in recent years have been the enactment of confusing, often conflicting and cumbersome boycott and foreign corrupt practice provisions. In addition, many United States laws in environmental and other areas have been applied to exports in a restrictive fashion. Moreover, private sector trade

> restrictions, unrelated to national security interests have been used in applying foreign policy.
>
> The time has come when we must quit enacting laws and promulgating regulations which hinder our ability to export. Needless laws and regulations should be eliminated and others should be simplified. In the longer run, it is necessary to address the question of comparability of tax treatment of American firms relative to foreign firms engaged in foreign exports. Overseas manufacturing companies engaged in trade are relieved of the burden of indirect taxes on foreign source income and a number of other taxes which apply to American firms engaged in exporting. We urge that the committee undertake a longer range program to reduce this disparity in taxes which favors foreign competitors over U.S. exporters. We call to your attention the conclusion of the trade negotiations in Geneva, and the Congressional reports on the MTN legislation which called for an international conference on taxes as they affect trade. The work of this Committee could be very useful in seeking a suitable American initiative in this respect.

S. 2757 is taken from title III of the Export Trading Companies Act of 1980, S. 2718. S. 2718 is intended to encourage exports by facilitating the formation and operation of export trading companies, export trade associations, and the expansion of export trade services generally.

Enactment of the export trading company provisions would be a positive step toward the necessary revitalization of U.S. exports. It would be of particular benefit to small- and medium-sized companies which are presently not exporting due to the cost and complexities of entering foreign markets. In addition, incentives would be provided for increasing export services.

We feel that this legislation is good for exports in that it demonstrates a changing and more favorable export trade policy for this country. However, enactment of this legislation will have a limited impact at best on our trade posture over the short run. Further, it is not comparable to, nor competitive with the export programs or export trading companies of other nations such as Japan. Additionally, because of the substantial complexities of interpretation of "service applications" as related to our tax laws, great care will be required in the regulatory language. Thus, it is only a beginning toward a more realistic export policy.

There are a number of other changes which should be considered. In the area of tax incentives, DISC is the only U.S. tax incentive to offset the myriad of foreign incentives. DISC should be simplified, strengthened and made more effective.

In the area of small companies, the qualification and reporting requirements for DISC should be simplified. In addition, DISC could be made more effective by increasing the small DISC exemption from the incremental growth in sales rules, and by extending DISC to cover smaller companies not directly involved in exporting, but supplying parts and components used in exported products.

Another important step would be for the Commerce and Treasury Departments to use DISC as a tool for encouraging exports. The effectiveness of DISC has been reduced by the negative statements and attitude of the administration over the last several years. The problem is illustrated by comments by H. David Rosenbloom, International Tax Counsel, Treasury. Mr. Rosenbloom is quoted as referring to DISC as an "excrescence and an unnatural growth on our tax laws."

This uncertainty with respect to the DISC program is magnified throughout our export policy. A major step would be for the Government to provide private industry with rules and policies which can be easily understood and consistently relied on by businesses engaged in international commerce.

In summary, the need for new and imaginative initiatives in the export area is apparent. The time has come to stop talking about our international trade problems and take constructive action. Enactment of 2757 will encourage and enhance the ability of some businesses to export. More importantly, it is a step toward a realistic export policy. Thank you.

Senator GRAVEL. Thank you, Mr. Babson.

[The prepared statement of Mr. Babson follows:]

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S.2757

To Encourage Exports and the Expansion of Export Trade Services by Providing for Special Provisions on Taxation of Export Trading Companies

Testimony

Presented to

The Senate Finance Subcommittee

On Taxation and Debt Management Generally

June 24, 1980

Submitted on Behalf of the

Special Committee for U.S. Exports

By

John R. Babson
Chairman Executive and Steering Committees
Special Committee for U.S. Exports
and
Vice President

Increased Employment Through Fair Taxes in World Trade

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American [illegible] Industries, Inc.
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[illegible], Inc.
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[illegible] Corporation

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[illegible] Corporation
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[illegible] Corporation

[illegible] & Company
[illegible] & [illegible] Land Company
[illegible], Inc.
[illegible] Manufacturing Company
[illegible] International
[illegible] Corporation
[illegible], Inc.
A. B. Dick Company
[illegible] Equipment Corporation
[illegible] Company, Inc.
[illegible] Chemical Company
[illegible] & [illegible] Manufacturing Company
[illegible] Industries, Inc.
[illegible] Corporation
W. R. [illegible] & Company
E. I. du Pont de Nemours and Company
The [illegible] Company, Inc.

[illegible] International
[illegible] Industries, Inc.
[illegible] Air Lines, Inc.
[illegible] Company
[illegible] Corporation
[illegible] Corporation
[illegible] Company
[illegible] & [illegible]
Corporation
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Engelhard Minerals & Chemicals
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[illegible] Laboratories, Inc.
[illegible] Company, Ltd
[illegible] Works
[illegible] Company
[illegible], Inc.
[illegible] Company
Gray Tool Company
Great Lakes Chemical Corporation
[illegible] Works, Inc.
[illegible] Manufacturing Company
Grumman Corporation
[illegible] Packaging Corporation

Hach Chemical Company
Hammermill Paper Company
[illegible] Corporation
[illegible] Corporation
Harper & Row, Publishers, Inc.
Harris Corporation
Harris Trust & Savings Bank
[illegible] Corporation
[illegible] Company
[illegible] Foods, Inc.
[illegible] Incorporated
[illegible] Corporation
[illegible] Chemicals & Plastics Corporation
[illegible], Inc.
[illegible] Manufacturing Company
Hughes Tool Company
Hy-Gain Electronics Corporation

[illegible] Company, Inc.
Illinois Tool Works Inc.
[illegible] Corporation
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Ingersoll-Rand Company
Inland Container Corporation
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International Paper Company

International Telephone & Telegraph Corporation
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[illegible] Bros., Inc.
Joy Manufacturing Company

[illegible], Inc.
[illegible] International, Inc.
[illegible], Inc.
Kerr-McGee Corporation
[illegible] Industries, Inc.
[illegible] Industries, Inc.
[illegible] Company
[illegible] Company
[illegible] Corporation
[illegible] Company, Inc.
[illegible] Corporation

[illegible] Industries, Inc.
La Pointe Industries, Inc.
[illegible] Company, Inc.
W. D. [illegible] & Company
[illegible], Inc.
[illegible] Corporation
[illegible] Bank, Inc.
The [illegible] Company
Lockheed Aircraft Corporation
[illegible] Industries, Inc.
Louisiana-Pacific Corporation
[illegible] Corporation
[illegible] Company
[illegible] Industries, Inc.

MTD Products, Inc.
[illegible], Inc.
[illegible] Controls Company
[illegible] Inc.
[illegible] Company, Inc.
[illegible] Machine Company
[illegible] Corporation
Maryland Cup Corporation
Massey-Ferguson, Inc.
McDonnell Douglas Corporation
McGraw-Edison Company
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[illegible] Corporation
[illegible] Company, Inc.
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Michigan General Corporation
[illegible], Inc.
Midland-Ross Corporation
[illegible] Company
Mine Safety Appliances Company
[illegible] Engineering Company
The [illegible] Machine Tool Company
Monsanto Company
[illegible], Inc.
[illegible] Tool Company, Inc.
Morgan Construction Company
The [illegible] & [illegible] Machinery
Company
[illegible], Inc.

NL Industries, Inc.
Nalco Chemical Company
[illegible] Industries, Inc.
[illegible] Industries, Inc.
National Distillers & Chemical Corporation
National Forge Company
National Starch & Chemical Corporation
[illegible] Resources, Inc.
[illegible] Industries, Inc.
North American Philips Corporation
Northern Natural Gas Company
Northern Petrochemical Company
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[illegible] Truck Corporation

PMC Industries, Inc.
PVO International, Inc.
PACCAR, Inc.
Pacific Lumber Company
Pan American Trade Development
Corporation
[illegible] International Corporation
[illegible] Company
[illegible] Corporation
Piper Aircraft Corporation
[illegible] Corporation
[illegible] & [illegible], Inc.
[illegible], Inc.
[illegible] Company
[illegible] Corporation
Prentice-Hall, Inc.
[illegible] Machinery Corporation
[illegible] and Company

Questor Corp

RCA Corporation
RayCo, Inc.
[illegible] Chemicals, Inc.
Reliance Electric Company
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Republic Steel Corporation
[illegible] Corporation
[illegible], Inc.
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[illegible] Controls Company
H. H. Robertson Company
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Rohm & Haas Company
[illegible] Industries, Inc.
[illegible] Corporation

San Fernando Electric Manufacturing Company
[illegible] Company
A. Schulman, Inc.
Scientific Atlanta, Inc.
Sealed Power Corporation
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The Sherwin-Williams Company
[illegible] Company, Inc.
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The Singer Company
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[illegible] Industries, Inc.
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Southern Aluminum Castings Company
Spectra-Physics, Inc.
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Sperry Rand Corporation
Springs Mills, Inc.
Standard Oil Company of California
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Stauffer Chemical Company
Sterling Drug, Inc.
[illegible] & Sons, Inc.
J. P. Stevens & Co., Inc.
[illegible] & Company, Inc.
Sun Chemical Corporation
[illegible] Electronics, Inc.
[illegible] Corporation
[illegible] Equipment & Systems Corporation
[illegible], Inc.
[illegible], Inc.
[illegible] Corporation

T. [illegible] Manufacturing, Inc.
TRW, Inc.
Tab Products Company
[illegible] Taylor & Son, Inc.
Tecumseh Products Company
[illegible], Inc.
Texas Eastern Corporation
[illegible] Corporation
Tiffany Industries, Inc.
[illegible] Corporation
Toro Company
Trane Company
J. M. Tull Industries, Inc.
[illegible], Inc.

UOP Inc.
Union Camp Corporation
Union Carbide Corporation
Union First National Bank of Washington
Union Oil Company of California
Union Special Corporation
United Industrial Corporation
United States Filter Corporation
U. S. Industries, Inc.
United Technologies Corporation
Universal Leaf Tobacco Company
Upjohn Company

VSI Corporation
[illegible] Corporation
[illegible], Inc.
Van Dusen Air Inc.
Varian Associates
[illegible] Company
[illegible] Inc.
[illegible] Corporation
Virginia Chemicals, Inc.

Wachovia Bank & Trust Company, N.A.
[illegible] Corporation
The Warner & Swasey Company
Warner-Lambert Company
[illegible] Company
Waverly Press, Inc.
[illegible], Inc.
[illegible] Company
[illegible] Corporation
[illegible] Corporation
Westinghouse Electric Corporation
[illegible], Inc.
[illegible] Seafoods, Inc.
[illegible] Corporation
T. D. Williamson, Inc.
[illegible] Industries, Inc.
[illegible] Manufacturing Company
[illegible] World Wide, Inc.
Worthington Pump Corporation (U.S.A.)
[illegible] Company

Zurn Industries, Inc.

Mr. Chairman, Members of the Committee:

My name is John R. Babson, I am Chairman of the Executive d Steering Committees of the Special Committee for U. S. xports and Vice President of Ingersoll-Rand Company. My tesimony is on behalf of the Special Committee.

The Special Committee is a participating group of more han 1,200 business concerns and 80 supporting business associtions whose operations and concerns are directed to the export f U.S. products. The Special Committee's major concerns are ith the effect of the U.S. tax system on exports by U.S. busiesses and the ability of those businesses to compete in forign trade in view of the many tax advantages and incentives nd direct and indirect subsidies provided to foreign competiors by their governments.

n General

The concerns of the Special Committee are set forth in the emarks of Ambassador Reubin Askew, United States Trade epresentative, on June 10, 1980 (attached as Exhibit A):

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> There may have been a time when we could simply assume in America that our high standard of living would grow higher and higher. But not any more.

There may have been a time when we could afford in America merely to react to economic issues as they arose and address them separately and without regard to their crucial interrelationships. But no more.

For several years we have been faced with international trade deficits, declining productivity and inadequate capital formation. This has lead to devaluation of the dollar -- inflation -- restrictive monetary controls -- recession and deficit spending. Looking at our international trade position over the last decade as a major factor, our present economic position is the expected result.

There has been a great deal of discussion of the need for increasing exports over the last several years. It is widely recognized that there are a number of areas where encouragement and incentives for U.S. exports will produce results. However, the preponderance of governmental action has reduced not increased exports. Examples of governmental action in recent years have been the enactment of confusing, often conflicting and cumbersome boycott and foreign corrupt practice provisions. In addition, many U. S. laws in environmental and other areas have been applied to exports in a restrictive fashion. Moreover, private sector trade restrictions, unrelated to national security interest, have been used in foreign policy.

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In the longer run it is necessary to address the question
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.2757

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mpanies Act of 1980 (S.2718). S.2718 is intended to en-
ourage exports by facilitating the formation and operation of
xport trading companies, export trade associations, and the
xpansion of export trade services generally.

The tax provisions in S.2757 make three amendments consistent with the export trading companies provisions. These amendments amend the Internal Revenue Code to:

1. permit bank investments in export trading companies without disqualifying them from status as a Domestic International Sales Corporation (DISC),

2. make receipts from exports of services or export trade services eligible export receipts for DISC, and

3. permit certain export trading companies to qualify as Subchapter S corporations (closely held corporations with 15 or fewer shareholders which are taxed in a manner similar to a partnership).

Another important provision requires the Secretary of Commerce in consultation with the Secretary of the Treasury to prepare and distribute information on how export trading companies could use DISC.

Enactment of the export trading company provisions would be a positive step toward the necessary revitalization of U.S. exports. It would be of particilar benefit to small and medium sized companies which are presently not exporting due to the cost and complexities of entering foreign markets. In addition, incentives would be provided for increasing export services.

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In the area of small companies, the qualification and eporting requirements for a DISC should be simplified. For a ore detailed explanation see Exhibit B. In addition, DISC ould be made more effective by increasing the small DISC xemption from the incremental growth in sales rules and by xtending DISC to cover smaller companies not directly involved n exporting but supplying parts and components used in exports.

Any program for exports must recognize that 85 percent of J.S. manufactured exports are exported by 1900 U.S. companies.

These companies are faced with extreme competition from equally large and often larger companies which receive many export incentives from their governments. Overall, DISC can be made more effective by returning to 100 percent deferral (originally proposed) for DISCs, eliminating the incremental requirements or freezing the incremental base period at present levels.

Another important step would be for the Commerce and Treasury Departments to use DISC as a tool for encouraging exports. The effectiveness of DISC has been reduced by the negative statements and attitude of the Administration over the last several years. The problem is illustrated in the attached Exhibit C containing comments of H. David Rosenbloom, International Tax Counsel, Treasury. Mr. Rosenbloom is quoted as referring to DISC as an "excrescence" and an "unnatural growth" on our tax laws.

This uncertainty with respect to the DISC program is magnified throughout our export policy. A major step would be for the government to provide private industry with rules and policies which can be easily understood and relied on by businesses engaged in international commerce.

Conclusion

In summary, the need for new and imaginative initiatives in the export area is apparent. The time has come to quit

lking about our international trade problems and take con-
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nt, it is a step toward a realistic export policy.

Thank you.

Exhibit B

S.2757 provides DISC eligibility to all export trading companies are defined in the Export Trading Company Act of 1980. The current DISC qualification and reporting provisions are too complicated for small businesses and must be simplified if S.2757 is going to stimulate small businesses to export goods. It is recommended additions to S.2757 to amend the DISC provisions of the Internal Revenue Code to benefit small businesses be in two parts: 1) qualification for DISC status and 2) DISC reporting requirements.

I. DISC Qualification

To qualify as a DISC, and thereby receive the DISC benefit, a business must meet statutory requirements which compel the formation of a separate corporation with $2,500 in capital to be a DISC. This presents onerous record keeping and reporting duties for small businesses such as meetings, filing state tax returns, and basically additional business for lawyers and accountants. Also many small businesses operate in non-corporate form and incorporation should not be necessary to obtain DISC benefit.

It is recommended that some of the qualification requirements for DISC status be different for small and large businesses. For DISC purposes, a small business might be defined as a business which has, for example, gross receipts from exports sales of $10 million or less. Small businesses should be permitted to receive the DISC benefit without being required to form a corporation and to maintain separate books and records. The DISC benefit would be computed under the objective pricing rules. Such an entity would not be able to use the section 482 principles. Furthermore, a small business receiving the DISC benefit should not be required to file a separate DISC tax return (Form 1120-DISC). The DISC benefit could easily be included as a section or line in the standard corporate (Form 1120) or personal tax (Form 1040) returns, such as was done for a Western Hemisphere Trade Corporation.

Another simplification of the DISC qualification requirements for small businesses would be to eliminate the "gross assets test". This test requires that at least 95 percent of a corporation's assets be "qualified export assets" as defined in the Code in order to qualify for DISC benefit. If this test were eliminated for small businesses, they would be allowed to invest in business assets as they wished, thereby removing a serious constraint for the small business. The asset test has limited application for such business and, in fact, adds one more complexity that easily can be avoided.

A transition period would be necessary in leaving room for error the small DISC must be converted to a regular DISC if it grows in volume.

II. DISC Reporting Requirements

The DISC tax reporting requirements contained in the Internal Revenue Code and Treasury Regulations are burdensome to small and large companies in that they require the gathering of extensive information regarding the ultimate destination of goods sold and also extensive international boycott information. If such reporting requirements are burdensome to present DISC companies, then they would most certainly be a serious discouragement to a business which wished to obtain DISC benefit through the Trading Company concept.

The reporting requirements should be modified to varied extents for large and small businesses to facilitate use of DISC provisions. First, as mentioned above, the small business, however that term would be defined for DISC return. Second, the extensive information regarding the ultimate destination of exported goods required by Schedule N of Form 1120-DISC should be eliminated for large and small businesses alike. Most companies, accounting system does not generate ultimate destination of goods information. Third, the extensive international boycott information required in the DISC return necessitates the completion of International Boycott Form 5713. Small businesses should not be required to file this information to obtain the DISC benefit. As for large businesses, they should be permitted to attach to their DISC return the Form 5713 boycott information submitted with their corporate tax return, even if the fiscal year of the corporation and the DISC are different. To require a business to gather this extensive information twice, once for the fiscal year of its DISC, is unduly burdensome and should be eliminated.

Exhibit C

In a Bureau of National Affairs interview on June 10, 1980, H. David Rosenbloom, Treasury's International Tax Counsel responded to questions on tax reform and priority issues and DISC as follows:

Reform Options

Q. For Instance?

A. Well, I believe the Domestic International Sales Corporation (DISC) incentive is clearly inefficient. I mean, it's vertually indefensible. Even some of the strongest proponents of tax incentives, some of the strongest business supporters, have not favored DISC. The Wall Street Journal has historically taken the position that DISC is a bummer. That would be one place I would look.

Q. The recent Treasury report on DISC did not shed favorable light on DISC, did it? Also, the Administration opposes DISC, and recommended that DISC and deferral be dropped in it 1977 reform package, did it not?

A. Sure. The (Treasury) reports, I think, are devastating. President Carter proposed the repeal of DISC and didn't get all that far with it. But my point is simply that even some the people that you might expect to find on the side of DISC are opposing it, and that's a fairly unsual thing because people have a very difficult time criticizing other people's tax benefits.

If we're going to do something that cost a lot of money, and it might conceivably make sense with respect to Americans abroad, I think we have to change our attitude toward some of the other things that we have in the law that just aren't working very effectively.

Now DISC is one that sticks out, but there are a number of others. You could go through the foreign tax area, and I think you could find a number of provisions that could reasonably be changed.

I think that if we are not to end deferral, which was another of the President's proposals, we could certainly amend subpart F in various ways that would tighten those rules. Subpart F has become a tax planning device and it seems to me that that would deserve some attention.

The overall limitation on the foreign tax credit is really quite generous by comparison with what most other countries in the world have in place. We were through that issue in 1976, and I doubt that there's much interest in getting back into it now, but the fact is that if you point to other countries under 911 and 913 and say, "we should adopt their rules for taxation of foreign residents," there are a lot of other respects in which I don't think people would be so happy with.

I would enjoy, I think, the opportunity of being charged with preparing a package of simplifying and reform proposals in the foreign area that would pick up the necessary money to spend on Americans abroad. I think that would be a worthwhile project, but I think it would be plenty controversial.

Priority Issues

Q. If you had to pick the areas of international tax legislation it would be most desirable to reform, what would you concentrate on?

A. I think that the whole area of the foreign tax credit is obviously a high-priority issue right now. I think that the place of tax treaties in our overall international tax system is by-and-large a front-line issue, and particularly the U.S.-Canada treaty is and will be a front-line issue.

I think implementation of the U.S.-U.K. treaty is a front-line issue.

I think that of considerably less importance in the big picture--but nevertheless a front-line issue--is taxation of real estate in the United States. Those are, I think, the really big issues that we're facing now.

Moving over to the more significant things, I think that we will in time undertake some fairly significant reviews of DISC. I mean, DISC is basically an excrescence upon our tax laws. I just cannot be convinced that it's there indifinitely. It's unnatural growth. If it were doing a lot of good for a lot of people that might be one thing, but out reports seem to indicate that it's not. It's costing an awful lot to do what it is doing.

I think that the section 936 (ed. definition of qualified possessions source investment income-Puerto Rican Tax credit) regime with respect to Puerto Rico is a big-ticket item that this Administration is not going to back into because it has been recently reviewed. But I think that if you pursue the reports that we have put out with respect to the operation of the possession system of taxation, there are grounds for believing that it is not working all that well. Certainly, it could stand some further improvement.

The 861-8 rules is another area which was reviewed extensively, but I think remains an important area, and it could be that at some point there will be further, attention there. Some people urge us to get back into that. Others are just as pleased that we don't.

I think the rules under section 482 deserve rethinking in light of the expreience...under the present regulations.

And I suppose the area of deferral. Deferral is by no means dead, and I include in that the question of subpart F, because there are a lot of issues that come up under subpart F.

One other big issue that is also fairly hot from our standpoint is currency. We have undertaken a project to review the rules on currency, which I think is going to be a fairly long-term undertaking but which we are badly in need of. Under current law a situation has arisen where exchange gains and losses were a lot less important than they are today, and where there was a lot less attention paid to them than there is today. That's a fairly big-ticket and a very complicated item.

Senator GRAVEL. Our next witness is Mr. John M. Hopkins, president, Energy Mining Division, Union Oil Co. of California. Mr. Hopkins?

STATEMENT OF JOHN M. HOPKINS, PRESIDENT, ENERGY MINING DIVISION, UNION OIL CO. OF CALIFORNIA, ACCOMPANIED BY ROBERT HARDING, COUNSEL

Mr. HOPKINS. Thank you, Mr. Chairman.

I am accompanied here today by Mr. Robert Harding, of the law firm of Groom and Nordberg. In case you have any technical questions, he will help me.

I am appearing today in my role as chairman of the Oil Shale Committee of the Rocky Mountain Oil and Gas Association to speak in favor of S. 2783.

The Rocky Mountain Oil and Gas Association is composed of some 750 member companies. The Oil Shale Committee of that association has as members most of the companies that are interested in the development of oil shale and who own most of the privately held oil shale properties.

We have a prepared statement that I would like to submit for the record, and then I will summarize it briefly.

Senator GRAVEL. It will be placed in the record.

Mr. HOPKINS. The Energy Tax Act of 1978 provided an energy investment tax credit for oil shale production facilities, but specifically excluded those facilities required for hydrogenation of the shale oil produced. S. 2783 provides for including the hydrogenation facilities to be eligible for that investment tax credit which we think will carry out the original intent of the Congress and remove an inequity that exists against oil shale as compared with other alternate fuel sources for which the investment tax credit does apply. It will treat oil shale the same as other alternatives.

It broadens the investment tax credit to include hydrogenation facilities, but not refining facilities used for refining of shale oil. It is not clear to us why this exclusion was provided, but it may have been due to misunderstanding of the process for production of shale oil or due to the haste at the end of the session in 1978. I would like to explain briefly what the process for producing shale oil is.

When shale has been retorted to produce a liquid hydrocarbon, that material is a heavy, viscous material that is unusable as a feedstock in any of the existing refineries in the country today. In order to be used as a feedstock for a refinery, it is necessary for it to be treated to remove certain impurities that exist in it and to render it usable in the normal existing refining facilities.

That process or those processes may take a variety of forms, but all of them do include hydrogenation in order to remove nitrogen and other steps to remove arsenic and other contaminants that are present in the crude shale oil as it is produced.

Thus, in order to produce a synthetic fuel that is of value as a refinery feedstock to produce transportation fuels to replace imported oil, it is essential that hydrotreating be included, and it is as essential as the retorting process itself. Therefore, we feel it should e accorded the same treatment as is accorded other synthetic fuels.

The principle we are seeking here is to produce a usable, marketable material from shale oil.

Our testimony indicates some of the potential of oil shale produc- ion as its potential for reducing our dependence on foreign oil. We ite three studies that indicate that shale oil will produce high alue, high quality transportation fuels, one by the Department of Energy, one by the Air Force, and one by General Motors.

We stress the importance to the defense establishment of the roduction of alternate energy sources, and I would point out to ou also that the tax credit, the energy tax credit is of limited uration, and is intended to apply only to the pioneer plants, and it ill be only applicable to those that are built at an early stage. Therefore, it is of relatively short duration.

We are convinced that the inclusion of hydrogenation facilities in he investment tax credit will stimulate and accelerate the rate of roduction of shale.

If there are any questions, we would be pleased to try to answer hem.

Senator GRAVEL. Mr. Hopkins, you have convinced me.

Mr. HOPKINS. Thank you, sir.

Senator GRAVEL. Thank you.

Does anyone else wish to be heard?

[No response.]

Senator GRAVEL. Thank you very much.

I have two statements here that are to be included in the record the end of Mr. Yould's statement on hydropower, and then there a statement by Senator Malcolm Wallop that will be placed in e record as if read, and that should follow Mr. Hopkins' state- ent, and then the statement of Teamster Local 959, State of laska, in support of S. 2075.

[The material referred to follows:]

STATEMENT OF

JOHN M. HOPKINS

REPRESENTING THE

ROCKY MOUNTAIN OIL AND GAS ASSOCIATION

IN HEARINGS BEFORE

THE SENATE FINANCE SUBCOMMITTEE ON ENERGY AND FOUNDATIONS

ON

S.2783

WASHINGTON, D.C.

JUNE 24, 1980

pages tightly bound

Mr. Chairman:

My name is John H. Hopkins. I am President of the Energy Mining Division of the Union Oil Company of California. I appear today in my capacity as Chairman of the Rocky Mountain Oil and Gas Association (RMOGA) Committee on Oil Shale.

RMOGA consists of about 750 member companies involved in energy production. The Committee on Oil Shale represents the full spectrum of those companies interested in oil shale development. I appreciate the opportunity to be here today to support legislation that will have a considerable positive effect on the development and use of oil shale, and on our nation's energy future.

S.2783 provides that equipment used in hydrogenation or similar upgrading of shale oil, or kerogen, shall be eligible for the 10% energy investment tax credit. Those of us in the shale industry feel that this is a logical and necessary broadening of the definition of "oil shale equipment" in the Internal Revenue Code. It would carry out the intent of Congress, remove an inequity in the current Code, and treat oil shale investment the same as other alternative energy investments.

Specifically, the definition of "oil shale equipment" under Section 48(l)(7) of the Internal Revenue Code as it now stands excludes expenditures for equipment necessary to upgrade and treat shale oil before it can be refined. The bill, S.2783, presently before this Subcommittee, would broaden the definition of shale oil property to include that upgrading equipment and nothing else. The bill does not expand the definition to cover equipment used in the refining of shale oil.

Mr. Chairman, we believe that when the Energy Tax Act was passed there was not a clear understanding of the type of product that would be recovered from shale rock. Many people seem to believe that the so-called "oil" that comes from the shale rock is a high-grade, commercial product. In reality, the opposite is true. Oil shale is a sedimentary rock containing a solid organic material called kerogen. Kerogen is a complex hydrocarbon which is removed from the rock primarily through heat treatment at about 900 degrees Fahrenheit. At that stage the kerogen is unsuitable for direct use or immediate or direct processing in a refinery. In fact, at this point of the process, the kerogen is a thick, tar-like substance that will not flow in pipelines, that could solidify in a refinery and gum up the works, and that contains chemicals and elements that must be removed before refining so that they do not poison the refinery catalysts.

The necessary process by which the kerogen is upgraded commonly called hydrogenation. It removes the impurities m the shale oil and makes it flow more easily. Upgrading cesses require large equipment and property investments, ding several dollars to the cost of a barrel of shale oil ich must compete with conventional oil prices.

The ineligibility of upgrading equipment expenditures der present law denies to shale oil the full benefits of e energy credit and results in a substantial inequity ong alternative fuels. By comparison, a much larger rcentage of expenditures for projects in coal gasification, quefaction, solar, ocean thermal, wind, gasohol, geothermal, d biomass will qualify for the extra energy credit. We rongly support the development of alternate energy forms and ek to put oil shale projects on an equal basis with regard to e energy credit. The product of an oil shale retort by itself not a marketable commodity and needs to be upgraded. Generally, e other energy sources listed above each qualify for incentives to their marketable form. For example, a similar process of drotreating coal liquids qualifies under the definition. This not true in the case of oil shale.

The members of the Senate Finance Committee have heard nsiderable testimony on the tremendous potential, both ar-term and long-range, of shale oil. I do not want to ver that gound again, unless there are specific questions.

I do want to point out, however, that there are an estimated 1.8 trillion barrels of shale oil in the ground in this country, with about 600 billion barrels considered recoverable with present technology. That means that the United States' shale oil recoverable reserve is about twice the known oil reserves of the Middle East. The Administration, based on positive recommendations from both the Department of Energy, and the Department of Defense, support of the development of this resource.

I would like to point out three recent developments which have come to my attention.

First, a study for the Department of Energy recently announced that synthetic fuel from shale is the most attractive option to replace kerosene-based jet fuel as the future aviation fuel, based on cost and fuel efficiency. Second, an executive of General Motors Corporation recently announced that gasoline from oil shale appears to be the best alternative fuel to replace gasoline from petroleum and urged rapid development of shale oil facilities. Third, the Air Force recently announced that shale oil can be refined for jet fuel which meets or exceeds military specifications.

I need not elaborate on what a strong domestic supply of gasoline and jet fuel would mean to the automobile and airline industry, and to the defense of this nation.

We believe S.2783 will have no impact on the budget several years because the expenditures for upgrading will mally come toward the end of the building of a shale oil ility. In the meantime, the broadening of the credit l give certainty, stability, and equity in developing g-lead time shale projects that must compete economically h conventional oil and gas.

Mr. Chairman, we believe S.2783 would carry out the iginal intent of existing law and remove the inequity for penditures for oil shale projects.

Thank you. I will be pleased to answer any questions.

Statement of Senator Malcolm Wallop

June 24, 1980

S. 2783

Hearing of the Subcommittee on Taxation and Debt Management

Mr. Chairman, I want to thank you for holding this hearing
h gives this subcommittee an opportunity to review S. 2783.
troduced S. 2783 in an effort to equalize the tax treatment
ived by oil shale equipment with the treatment received by the
r categories of synthetic fuel equipment. This legislation
ly expands the definition of shale oil properly so that the
pment used in hydrogenation or similar upgrading methods will
eligible for the 10% energy investment tax credit. Similar up-
ing processes used in the production of liquid fuel from coal
covered by the energy credit. There is no reason to leave shale
, our most promising near-term synfuel alternative, at a com-
itive disadvantage to other synfuels.

Unfortunate international developments in the pricing and
duction of oil guarantee that some day oil shale will be com-
cially produced in this country. This legislation will not
ermine whether oil shale is developed on a commercially viable
el, but it will influence how soon oil shale production can come
stream. The enormous capital expenditures and long lead times
uired in building an oil shale production facility have caused
ustry to hesitate in going forward with oil shale development.
10% energy investment tax credit will help accelerate the
elopment of an oil shale industry. By extending the energy in-
tment tax credit to upgrading facilities we can be assured that
s segment of an oil shale project will proceed on the same
edule as other energy property that qualifies for the credit.
der the new affirmative commitment rule adopted by the Finance
mittee as an amendment to the Crude Oil tax, energy investments
st proceed under a time table, making substan-

tive commitments to an energy project in order to qualify for the credit. By denying the energy tax credit to oil shale upgrading processes, we create no incentive for this type of equipment to proceed on the schedule prescribed by the new affirmative commitment rule. In fact, by leaving one segment of am oil shale facility ineligible for the tax credit, we invite distortions in the decision making process of corporate planners.

Under the present circumstance it would be logical to defer investments in upgrading facilities and channel all discretionary capital into the oil shale equipment that qualifies for the energy investment credit. This would be done to assure that the necessary financial commitments are made under the affirmative commitment rule. It is probable that investments in non-qualifying upgrading equipment would proceed at a slower rate than the rest of the oil shale project. The resulting delay in bringing oil shale facitities into commercial production would be an unfortunate and I believe unintended consequence of denying the tax credit for oil shale upgrading equipment.

I do not believe that Congress intended to create this kind of tax distortion between segments of an oil shale facility, nor do I believe that Congress wanted to create inequities in the tax treatment of different kinds of synfuels. If my understanding of the energy goals of this nation is correct, Congress wants to accelerate the production of alternative fuels. To the extent that this legisaltion will accelerate the production of oil shale, and address the distortions mentioned above, I believe this is a necessary technical correction in the tax laws.

I would like to conclude by indicating that to a great extent my interest and the support of Senator Garn in this legislation stem from the importance of shale oil in meeting the future mobility requirements of the U.S. military. Once shale oil has gone through the hydrogenation or other upgrading processes, it can be refined into jet fuel. Jet fuel from oil shale has been tested by the U.S. Airforce, proving that it can be used by the military. The Department of Defense has testified on the potential role that oil shale can play in developing a secured supply of domestic energy that can be used by the military. I have asked the Defense Department to comment on the potential uses of oil shale in the future. If there is no objection, I would like to request that the record remain open so that these comments from DOD can be placed in the hearing record.

THE DEPUTY SECRETARY OF DEFENSE
WASHINGTON, D.C. 20301

'80 JUN 30 [illegible] 10 33

JUN 26 1980

Honorable Malcolm Wallop
United States Senate
Washington, D.C. 20510

Dear Senator Wallop:

This is in response to your June 17, 1980, letter which requested my views on the need for rapid development of shale oil as an alternative mobility fuel, particularly to meet defense needs. Your letter referred to my testimony, and that of other Department of Defense or Department of Energy witnesses, before the Investigations Subcommittee of the House Committee on Armed Services on October 10-12, 1979. At that time, we emphasized the importance of oil shale as a secure domestic source for mobility fuels.

I am pleased to reaffirm to you my conviction that oil shale-derived synthetic fuels are of vital importance to satisfy future defense mobility fuel requirements. Due to the state-of-the-art of synthetic fuel technology, oil shale, as compared to coal and tar sands, appears to be the most attractive source of synthetic mobility fuels during the next five to ten years.

We are continuing to test shale-derived synthetic fuels in subsystem components, as well as aircraft, ships, and ground vehicles. Our test results to date have been very favorable. Accordingly, the Department of Defense stands ready and able to use shale-derived synthetic fuels as soon as they are commercially available.

Regarding synthetic fuel commercialization, we expect to play a major role in accelerating the development of a domestic synthetic fuels industry. When the President signs S. 932, the Energy Security Act, into law, I anticipate that the Defense Fuel Supply Center will act on behalf of the Department of Energy to make long term commitments for synthetic fuels, e.g., price guarantees, purchase agreements, and loan guarantees, during an interim period until the Synthetic Fuels Corporation is operational. Shale-derived fuels for military use will be a major commodity in those transactions.

In summary, the Department of Defense continues to maintain an intense interest, as well as play an active role, in the development of a domestic synthetic fuels industry. We applaud any action that you may take to accelerate further that process.

I trust that my comments have been helpful. An identical response has been sent to Senator Garn.

Sincerely,

W. Graham Claytor Jr.

W. Graham Claytor, Jr.

STATEMENT OF GENERAL TEAMSTERS LOCAL 959 STATE OF ALASKA IN SUPPORT OF S. 2075

We have experienced a problem with the Internal Revenue Service's interpretation of the excise tax on transportation that imposes an unjust burden on our attempt to minimize the cost of our transportation which we provide for union purposes and members. In seeking to impose the transportation tax on the situation which we shall describe, it is our view that the Service misconstrues the legislative intent of Congress. In view, however, of the Service's position, we propose that you consider the appropriateness of a legislative amendment which is very narrow in scope.

The Problem. -- IRC § 4261 imposes an excise tax (at an 8% rate) on an amount paid for taxable transportation of any person by air. (A similar tax also is imposed on the transportation of property by air by IRC § 4271.) The entire rationale underlying this tax is to impose a levy when one person "furnishes" transportation (at a cost) to another person. Thus, if a corporation owns (or leases) an airplane for use by its executive personnel, no transportation tax would be imposed when that aircraft is used by the owner (or lessee) because the corporation involved would not be "furnishing" transportation to any other party but simply operating the plane for its own use.

Occasionally, however, the aircraft is used by several affiliated corporations. For example, a plane may be owned by a parent corporation but used by the executives of its two wholly-owned subsidiaries as well. In such a situation it would be common for the parent and the two subsidiaries to share in the cost of the plane's operation (each paying that amount attributable to its use). In such a situation, the Service originally took the view (in Rev. Rul. 68-343, 1968-1 Cum. Bull. 491) that the corporation deemed to own the plane (the parent in this instance) was considered to be "furnishing" transportation to the two subsidiaries. Thus, the amounts paid to the parent corporation by the two subsidiaries (as their pro rata share of the plane's operation) would be considered, under Rev. Rul. 68-343, as an amount paid for transportation and, hence, subject to the excise.

When Congress was informed of this situation, it corrected the matter, in P.L. 91-258, by providing (in what is now IRC § 4282) that no transportation tax would be due where the aircraft is used only by members of an affiliated group (as that term is defined in IRC § 1504(a)). Since the parent and two subsidiaries in the above example would be an "affiliated group" no transportation tax would be imposed.

The enactment of IRC § 4282 was clearly prompted by the restrictive interpretation given to the transportation tax by the Service in Rev. Rul. 68-343. Congress recognized, through e enactment of this provision, that cost sharing arrangements tween entities that were commonly owned did not involve a tuation where one person was "furnishing" transportation to other. Each participating entity was simply paying its are of the aircraft's operation--no transportation was being ovided to another.

The amendment which Congress adopted (in the form of C § 4282) is not, however, in the Service's view, broad ough to cover other situations deserving of inclusion within e scope of a provision which recognizes that cost sharing rrangements do not involve the "furnishing" of transportation. e the Service's interpretation of IRC § 4282 in Rev. Rul. 6-394, 1976-2 Cum. Bull. 355. The reality of this has been trikingly brought home to us at Teamsters Local 959 which, n conjunction with its related Alaska Teamster Employer trusts, hare the cost of the expenses of operating an aircraft. This ircraft is used not only for transporting union local personnel n official business but, also, for the benefit of its related mployer trusts which are created and operated for the benefit of the union membership. For example, a significant use of this aircraft is for the purpose of evacuating injured union members from locations which are removed a considerable distance from medical or hospital care. In reality, therefore, all of the use of the aircraft is on behalf of Local 959 in the sense that it is for the benefit of its membership. No furnishing of transportation to another entity is involved.

These employer trusts which share the cost of the aircraft's operation (proportionate to their use) are not "owned" by Local 959 through stock ownership. They are (there are four in number: the Alaska Teamster-Employer Welfare Trust, the Alaska Teamster-Employer Prepaid Legal Services Trust, the Alaska Teamster-Employer Training Trust, and the Alaska Teamster-Employer Pension Trust), like Local 959 itself, exempt organizations. The creation of these organizations grew out of collective bargaining agreements between Local 959 and various employers. Although these trusts are not "stock owned" (i.e., Local 959 does not own them through stock as a parent corporation would own a subsidiary), they are operated for the benefit of the same group of individuals (i.e., the union's membership as Local 959). Since these entities are, however, trusts, not corporations, they are not, in the Service's view, an "affiliated group" within IRC § 4282.[1/]

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[1] As previously indicated IRC § 4282 adopts a narrow definition of affiliation--that used in IRC § 1504(a) defining the types of corporations which are eligible to file consolidated returns. Nevertheless, believing that the Congressional intent was such as to permit cost sharing arrangements between non-stock entities (such as a labor union local and its related trusts) to be eligible for non-payment of the transportation tax, Local 959 applied to the IRS for a favorable ruling. The Service adopted a very technical interpretation of IRC § 4282 and reached a tentatively adverse position on the ruling request. This caused Local 959 to withdraw its ruling request. It is only at this point that we concluded it was necessary to ask that legislative relief be considered.

hus, even though Congress has recognized that cost sharing etween affiliated entities does not involved the type of "furnishing" of transportation which should be subject to he transportation tax, a cost sharing arrangement between ocal 959 and its related trusts will not, according to the ervice, qualify as being within the definition of "affiliated" et out in IRC § 4282.

It appears to us that it is unfair to render Local 959 nd its affiliates ineligible for the IRC § 4282 relief simply ecause they happen to conduct their affairs in the form of ntities which are non-stock. Exempt organizations, such as nion locals, are usually non-stock in nature. The related ntities, being trusts, do not issue shares such as would ermit them to be owned, through that medium, by Local 959. And yet the arrangement which Local 959 (which leases its aircraft from a leasing company) has with its related trusts is every bit as much a cost sharing arrangement as any such plan between a corporation and its subsidiaries. If the latter is exempt from the transportation tax, and they would be by reason of IRC § 4282, so should a cost sharing arrangement between a union local and the trusts which it creates to serve its membership. The same commonality of benefit and interest which marks an "affiliated group" as defined within IRC § 1504 is present when a union local and its related trusts are concerned.

Congress realized, when it enacted IRC § 4282, that cost sharing arrangements between related corporations should not be subject to the transportation tax. Exempt organizations may share the cost of an aircraft's operation in the same way and yet, under the Service's view, no relief is provided for them. This cannot be regarded as a sensible legislative solution.

The Recommended Solution. -- The inequity referred to above can be cured very simply by providing that labor organizations, and their related entities, can be treated in the same manner as affiliated corporations. This is exactly what Senator Gravel's bill, S. 2075, accomplishes. This bill simply amends the definition of "affiliated group" to provide that such term includes labor organizations and other trusts or entities which are "established for the sole and exclusive benefit of the members of such labor organizations and their families and dependents." By this amendment, treatment which is parallel to that presently accorded taxable corporations can be given to labor organizations, and their related entities, which share the cost of aircraft used solely in connection with labor organization business.

Senator **Gravel**. The hearing is adjourned.

[Whereupon, at 5:25 p.m., the subcommittee was adjourned, subject to the call of the Chair.]

[By direction of the chairman the following communications were made a part of the hearing record:]

estimony by Senator Gary Hart
efore the Senate Finance Subcommittee on
Energy and Foundations
e S. 2783
une 24, 1980

Mr. Chairman, S.2783 provides that equipment used in upgrading of shale oil shall be eligible for the 10 percent energy investment tax credit. As a cosponsor of this amendment and as a Senator from a state with extremely high reserves of oil shale, I urge the Committee to act favorably on this measure.

The existing 10 percent energy investment tax credit applies to equipment used to mine shale, or to equipment used to process the shale rock into shale oil. The shale oil resulting from most oil shale processing plants, however, is not a liquid suitable to be put directly into a petroleum refinery. The crude shale oil needs to be upgraded, a process called hydrogenation, to make it a suitable substitute for petroleum.

The Internal Revenue Code, section 48 (1)(7), excludes expenditures for equipment necessary to upgrade and treat shale oil before it can be refined. S.2783, broadens the definition of shale oil property to include that upgrading equipment.

Upgrading processes require a large investment, adding several dollars to the cost of a barrel of shale oil, before it can compete with conventional petroleum. Since this is a necessary investment for most shale processes, it is reasonable to include the upgrading facilities in the ten percent energy investment tax credit.

By broadening the definition, as proposed in this bill, the Congress will be putting synthetic fuels from oil shale on an equal footing in tax code with synthetic fuels from other bases. The tax credit currently available for coal, for example, would normally be available for all the equipment that would eventually result in a product which is roughly the equivalent to petroleum, and sometimes equivalent to a refined product such as premium gasoline. It is only shale processes that result in an intermediate product, which requires upgrading before it can be used in a conventional refinery.

Mr. Chairman, it is important that this country do all it can to reduce oil imports as soon as possible. While shale oil will take perhaps a decade to become an important contributor to America's energy supply, it will make a very significant contribution. By providing selected tax credits, the Federal government will be stimulating investments in synthetic fuels at a faster pace and, thereby, reduce oil

mports sooner. I introduced the bill you are now consider-
ng as an amendment to the windfall profits tax last December.
nfortunately, due to the Senate Floor dynamics, this amend-
ent could not be brought to a vote. I am happy that Senator
allop introduced this amendment now, and I'm gratified that
he Finance Committee is studying it closely.

This bill is a minor, but fair, extension of the tax
redits as they apply to the development of synthetic fuels
rom shale. I hope the Committee will report on this bill
avorably.

Statement of Hon. Walter D. Huddleston (D-Ky)
Before the Subcommittee on Taxation
and Debt Management
Committee on Finance
United States Senate
June 24, 1980

Tobacco Excise Tax Collection Procedures

Mr. Chairman, Members of the Subcommittee, thank you for this opportunity to submit testimony in these hearings addressing a number of bills to provide tax relief to taxpayers or make other needed revisions to the Internal Revenue Code.

Mr. Chairman, under the President's cash management initiatives the collection of a variety of taxes would be accelerated. In some cases the cash management initiatives require special legislation for implementation. In other cases, the Administration has taken the view that tax collections can be accelerated without new authority from Congress.

In my comments I shall address the proposal to accelerate the collection of Federal tobacco excise taxes, as set forth in proposed regulations published in the June 6, 1980 Federal Register. These draft regulations would require the major tobacco manufacturers, who have major facilities in the Commonwealth of Virginia, the Commonwealth of Kentucky, and other States, to file a return every seven days based upon accrued tax liability during the preceeding week, with remittance to the Treasury three days thereafter. Under current regulations, in force since 1965, the tobacco manufacturers are quired to file a return every fifteen days, with remittance of xes fifteen days later. The economic effect, Mr. Chairman, of is proposal is to require the tobacco manufacturers to remit taxes e to the Treasury well in advance of collections of those taxes om industry customers.

In one study which I have seen, prepared for The Tobacco stitute by Coopers & Lybrand, the tobacco manufacturers under e present collection procedure endure an average daily cash ficit in their Federal excise tax account of more than $65 million. der the Administration's plan, these same manufacturers would stain an average daily cash deficit of more than $206 million. At e cost of overnight money, this increase in tax liability before ecovery from industry customers of taxes paid will result in substantial increases in costs of operation for the manufacturers.

Mr. Chairman, this subcommittee has before it one proposal y the distinguished Senator from Ohio (Mr. Glenn) to increase the ime for payment of Federal excise taxes on tires and other products. enator Glenn's bill is in response to the burden of paying excise axes before reimbursement for those taxes. It is an appropriate ill; most taxpayers are not required to pay their taxes before they arn the money upon which the taxes are based.

I would urge your subcommittee to amend Senator Glenn's bill, or another appropriate vehicle, to ensure at least that the status quo is maintained in the procedures for collecting tobacco excise taxes until this subcommittee has had adequate opportunity to review the problem.

Such an amendment could take the following form, as an amendment to section 5703(b) of the Internal Revenue Code: After the third sentence of such subsection of the Internal Revenue Code, insert the following new sentence:

> "No taxpayer hereunder shall be required to file or remit payment earlier than would have been required under regulations in force under this section on January 1, 1980.".

The adoption of this amendment, or an amendment accomplishing the same objective, would not alleviate the current problems faced by cigarette manufacturers in meeting the tax collector's time limits. But it would have the salutary effect of preventing further damage while Congress reviews the problem.

Mr. Chairman, the proposal to require cigarette manufacturers to remit their taxes every seven days, based upon tax liability accrued upon removal from the factory, simply ignores industry practice in distributing and marketing the product. The time that elapses between removal from the factory, and ultimate sale from a regional warehouse, is not acknowledged and not accommodated. Thus tobacco manufacturers sustain tax liability, and make tax payment, long before title to the product passes to the industry's customers.

This practice is inequitable today with the fifteen day porting period and the fifteen day remittance period. It would an unconscionable practice if the regulations proposed by the easury are permitted to go into force.

Therefore, Mr. Chairman, I urge your subcommittee to address mediately this problem, and take action to deter further erosion the industry's position while preparations are made in Congress r a careful and thoughtful evaluation of the entire process of cise tax collections within this major industry.

Thank you, Mr. Chairman, for this opportunity to submit ese comments on an issue of major importance in Kentucky.

Walter D Huddleston

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June 6, 1980

The Honorable Harry F. Byrd, Jr., Chairman
United States Senator, State of Virginia,
Subcommittee on Taxation and Debt Management
Senate Committee on Finance
Room # 227
Dirksen Senate Office Building
Washington, D. C. 20510

Dear Senator Byrd:

Thank you for this opportunity to express my views before the committee on the "Windfall Profit Tax." I. How did Congress ever allow a tax so misnamed pass without a change in name.

The president sent this bill to Congress with this misnomer to deceive the public—and perhaps some members of Congress—into thinking that this tax was a tax on profit. When in reality it is a tax—an excise tax—on each barrell of oil produced in the United States. Why was this name not changed in the Congress to make the meaning clear and understandable by the general public?

This misnomer "Dindfall Profit Tax" has made the general public believe that only the profit of the BIG OIL COMPANIES is taxed. The general public does not know the hardship that this excise tax has placed on persons in the same situation as I am.

My entire life has been one of work. For thirty-six years I have been a real estate broker in a small South Arkansas town, El Dorado. Out of a small amount that was saved—after taxes—with the help of a loan from the First National Bank, El Dorado, an investment was made in producing oil which I hoped would supplement my income when I reached 65. After the bank loan was paid, I mortgaged that production and bought a larger royalty interest in producing oil, on which I am still paying to the bank.

My situation is the same as thousands of others. I am a widow, without children, past 65 years old and this "Windfall Profit Tax," has taken one/third of my income. With this tax imposed on each barrel of oil, I will never get the bank paid, and I will not be able to retire at anytime. I must continue to work to try to keep everything together. With inflation taking ever increasing tolls on the small business, it is hard to survive. In 1945 a 500-roll of stamps was $15; today that same 500-roll of stamps is $75. Every expense of business and living is in like proportion to the stamps.

In April in Washington I visited the offices of a number of senators and congressmen—all of the Arkansas delegation and others from surrounding states whom I knew. One senator told me that he did not realize that the tax was an excise tax and only after he studied it carefully was he able to see the harm that the tax would do. How many senators failed to read the bill carefully and voted on it thinking that it was a "windfall Profit Tax?" This one senator voted against it after he studied the bill.

In a letter dated April 11, 1980 from The Honorable Dale Bumpers, Senator of Arkansas, on page 2, he writes:-"The consumers will actually be paying the tax because under decontrol they must pay whatever prices the Opec Cartel sets. Every barrel of oil will now bring the OPEC price,and there is no relationship between that price and the cost of finding domestic oil. Yet, without a tax, the oil companies would receive all of the money, as dictated by the cartel." Paragraph. "Finally, some people have argued that the revenues from the tax are not needed, but sixty percent of those revenues will be set aside for tax reductions. For example, the bill provides a tax break for interest earned on savings accounts. Currently,Americans are saving only a very small fraction of their incomes. The bill will increase the incentive to save by removing the tax on the first 200 dollars of interest ($400 on a joint return)."

How do I pass my taxes on to the consumer? It comes out of income and I do not have an oil company. Why set aside sixty percent of the revenues from the tax to give a tax break to interest earned on savings accounts?

Why should Americans receive less for their oil than the OPEC cartel? During the last twenty-five years our big oil companies have become international corporations—even our own home town company, Murphy Oil Corporation, founded in El Dorado. The reason for this was the smothering regulations imposed by the Federal Government. In the 1950's in a discussion with an official of Gulf Oil Company, who was an official in their overseas operation, he said that we would use up the oil reserves in foreign countries and that we would still have plenty of oil in America. At that time we were not dependant on foreign oil. But regulations kept multiplying and the companies that could fled to foreign lands to seek oil and developed the oil in the OPEC CARTEL.

This left the small independant operator who was willing to gamble and to struggle under the burden of regulations. Senator Bumpers said that there was no relationship between the price and the cost of finding domestic oil. There is a definite relationship. Without the small independant oil operator, South Arkansas would have been without exporation for the past 25 years. Within the last five years major companies have been drilling, but these have been few.

Seeking oil is the biggest gamble of any business venture. In wildcat fields—that is a place where the geology looks promising and no production exists—one well in about ninety proves successful. The cost to drill a well to a total depth of 6,000 feet averages from $120,000 to $200,000. This does not take into account the completion of that well. To drill and complete the average 3,000-foot-well in South Arkansas is from $70,000 to $100,000. There is a definite relationship in cost and price.

Why would the United States Government favor the OPEC CARTEL over her own oil producers? There should be no price regulation on domestic oil and there should not additional excise tax such as the so called "Windfall Profit Tax."

Americans can save very little with today's inflation and taxes. But is it right to tax royalty owners like me and take that tax money to give those who save money a $200—interest earned tax exemption?

Money lying in a bank never appealed to me, but to go out to see an oil well pumping, men working, and to know that a little bit of the operation was an interest that I had did. Having grown up and lived all of my life in the area where oil was produced, I have been very interested in the industry.

My father, the late J. V. Spencer, organized The Victoria Oil Company in 1916. That company drilled a number of wells in Union County, Arkansas. All were dry. By 1920 the company was dissolved, all debts were paid, and all the money put into it was lost. This is one of hundreds of others that had the same fate in seeking oil in South Arkansas.

There was few H. L. Hunts here in South Arkansas; but many Dry Hole Joe's. I have spent a lifetime watching the operations in the oil industry. H. L. Hunt came here and opened a gambling hall during the oil boom of 1921. He acquired a lease and luckily hit it big—and then drilled a number of dry holes and had dissipated his cash when the East Texas oil field came in during 1930. Pete Lake, a local business man, staked Mr. Hunt on his venture in East Texas when he left El Dorado. Few are willing to take the risks involved in seeking oil. And very few of those who take the risk are successful.

The big oil companies like Exxon probably favored this so called Windfall Profit tax because it would eliminate the small independant oil operator. Exxon can pass the tax on to the consumer. Where can the small independant oil operator and the land owners pass this tax on to? Please use every means possible to eliminate this tax on the ones who are being hurt the most.

If this tax were eliminated on the first 1,000 barrells of oil produced each day, those who are suffering under this tax burden would have relief. This would take care of those in the situation that I am in and the small independant oil operators. And these men and women who have kept the oil rigs drilling for the past 25 years in South Arkansas have been the back bone of our oil industry in South Arkansas.

Thank you for this opportunity to express my views. Remember the words of Thomas Jefferson, "The power to tax, is the power to destroy." Taxation and regulation bankrupt the American railroad system. Now, the government is spending millions to keep Amtrack operating. Do not let this happen to our oil industry.

Yours sincerely,

Annie Laurie Spencer

ALS/dd

Mr. Michael Stern
Staff Director
Committee on Finance
U.S. Senate
Washington, D.C. 20510

June 26, 1980

STATEMENT ON S.2784

The Engineering and Construction Group of Koppers Company, Inc., headquartered in Pittsburgh, has been building coke oven batteries for the past 70 years. We are currently the largest U.S. designer and builder of coke plants. Additionally, Koppers owns and operates three of its own coke plants. This experience, we feel, qualifies us to comment on both the coking industry and its effect on today's steel industry.

Most of these ovens produce metallurgical coke for use in the blast furnaces of the major steel companies. The other principal end product is foundry coke for metal castings.

Approximately 75 per cent of current U.S. steel production is dependent on blast furnaces which require metallurgical coke to melt the iron ingredients. To be both competitive and efficient, large scale facilities are vital to the industry.

In the past five years only two new, large-diameter, blast furnaces have been constructed: Bethlehem Steel Corporation's furnace at Sparrows Point, Maryland, and United States Steel Corporation's furnace at Fairfield, Alabama. Another new blast furnace, one of the largest in the Western Hemisphere, will be placed in operation by Inland Steel Company this fall at its Indiana Harbor Works. Only these U.S. facilities can match the production per unit volume of Germany, Japan and other world steel makers.

To provide the coke for these new furnaces, both Inland Steel and U.S. Steel built new, high-capacity, technologically-advanced coke oven batteries which are both environmentally and energy efficient. Bethlehem Steel presently has a similar new battery under construction. The energy tax credit in the Windfall Profit Tax Act, with an effective date of December 31, 1979, will not apply to either Inland or U.S. Steel because their batteries were built shortly before the effective date.

These two steel companies, Koppers, and others, have all either built new, or rehabilitated older batteries. These projects would have qualified for an energy tax credit if the coke oven amendment had been changed back to the effective date of the Energy Tax Act of 1978. This, as you are aware, was not done.

S. 2784 would rectify this inequity by making September 30, 1978 the effective date of the "coke oven" amendments to the Windfall Profit Tax Act.

Contd. Page 2

The steel and coke industries are vital to the nation's well-being, yet our coke production capacity has been declining for years. The problem lies with the age and deteriorated condition of our coke production facilities. Much of the equipment has decayed to a point where it cannot be operated efficiently or in compliance with ever more restrictive environmental regulations. Rehabilitation or complete replacement is vital. The cost of this replacement is staggering -- from $200-$225 per annual ton of production. (Last year's coke production level was 52.9 million tons.)

The low profitability of the steel industry has forced them to import coke to meet their needs. This occurs despite the fact that the U.S. has the largest and best coking coal reserves in the world. In 1978 and 1979, approximately 9.7 million tons of coke were imported into the U.S. These imports contribute to our balance of payments deficit and, more importantly, contribute to the loss of many thousands of jobs by coal miners and coke plant workers.

Importing coke also leads to an energy loss. The U.S. steel industry consumes nearly 3 quadrillion Btu's each year: 4 to 5 per cent of total domestic energy usage, equalling 500 million barrels of oil per year. However, the steel industry furnishes two-thirds of its own energy, derived from coal, our most abundant energy source. Most of this coal is used in coke plants which produce valuable coal-chemical by-products, including medium Btu by-product gas used as a substitute for petroleum and natural gas. Coke ovens are, in fact, presently the only full-scale, production-tested coal gasifiers in commercial operation in the U.S. They are already the kind of alternative energy source our government is encouraging through its synthetic fuels programs. We cannot let the coke industry deteriorate and decline.

The industry needs help from Washington. This legislation is a very positive step. A bill is also needed to allow the accelerated write-off of new capital facilities. S. 1435, the Capital Recovery bill would provide a strong surge of capital investment throughout the country, provide incentive to rebuild the ailing coke and steel industries, and put people back to work.

We do not want or approve of subsidies or handouts. Our objective is solely the establishment of governmental policies which will permit the coke and steel industries to regain good economic health and to achieve full potential under the private enterprise system.

Joseph A. van Ackeren
Manager, Marketing

JAVA/bjg

STATEMENT OF
NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE
JUNE 24, 1980

I. INTRODUCTION

The National Machine Tool Builders' Association is a national trade association representing over 370 American machine tool manufacturing companies, which account for approximately 90% of United States machine tool production.

Although the total machine tool industry employs approximately 110,000 people with a combined annual output of $4.0 billion, most NMTBA member companies are small businesses with payrolls of 250 or fewer employees.

While relatively small by some corporate standards, American machine tool builders comprise a very basic segment of the U. S. industrial capacity, with a tremendous impact on America. It is the industry that builds the machines that are the foundation of America's industrial strength. Without machine tools, there could be no manufacturing; there would be no trains, no planes, no ships, no cars; there would be no power plants, no electric lights, no refrigerators and no agricultural machinery.

We are pleased to briefly comment on the subject of export promotion and development, an area of vital interest to both American machine tool builders and U. S. industry generally. Specifically, we will address our remarks to S. 2757, introduced by Senators Bentsen, Stevenson, Heinz and Danforth, which would provide special provisions for the taxation of export trading companies.

We commend the sponsors of S. 2757 for lending their support, in the form of export tax incentives, to the overall export trading company concept. As you know, the Senate Banking Committee has recently reported its legislation in this area, S. 2718. We commend the Banking Committee for its judicious and expeditious consideration of that important legislation. The combination of S. 2718, with its broad scope approach to the export trading company (ETC) concept, with S. 2757's specific tax treatment of ETC income, will provide an export trading company program which will be of immense assistance to U. S. enterprises already involved in foreign trade, and we believe will serve as important encouragement to businesses which are reluctant to enter the export market under the current conditions.

II. U. S. MACHINE TOOL INDUSTRY'S RECENT EXPORT EXPERIENCE

Before proceeding with our specific comments, we would first like to briefly outline the U. S. machine tool industry's recent experience in the export market.

It is significant to note that while the domestic U. S. machine tool market has been oscillating with very little real growth since the middle 1960's, the world market has grown substantially. Unfortunately, most of this worldwide expansion has been absorbed by our foreign competitors, eroding our market share.

In the middle 1960's, the American machine tool industry supplied approximately one-third of the total global market. In other words, one out of every three machine tools consumed in the world was produced by an American machine tool builder. However, according to American Machinist, as of the end of 1979, that portion has fallen to only 17.1%. In short, over the past 13 years, our share of the world market has plummeted by almost 50%.

This dramatic decline is the result of two factors. First, our domestic market has been invaded by foreign competitors on a scale never before dreamed of. For example, since 1964, America's imports of foreign machine tools have more than tripled, growing from 7% of total consumption 15 years ago to 24% in 1979. It is obvious that because the United States is the largest open machine tool market in the world, our foreign competitors have pulled out the stops and are aiming their export marketing efforts at America.

Second, and this is the aspect that we wish to focus on at this time, our share of the export market has also declined. When we look at the dollar value of our exports, the results of our efforts look encouraging. But if we look at American exports as a percentage of all of the machine tool exports in the world, the results are discouraging. We have been losing export market share at an alarming rate. Specifically, our share of the world's machine tool exports fell from 21% in 1964 to just 7% last year, placing us well behind West Germany and Japan as a machine tool exporting nation.

Finally, and perhaps most alarmingly, in 1978 the United States suffered its first machine tool trade deficit in history, with imports exceeding exports by some $155 million. And, to make matters even worse, this deficit trend continued through 1979. Even though our exports grew by 15.8% over 1978 levels, imports soared by more than 45% to produce an even larger trade deficit of almost $400 million.

From these statistics it is obvious that export sales must play an increasingly significant role in the marketing strategy of American machine tool builders specifically, and all U. S. businesses generally. Also, it is important to point out that although there are some members of our industry who are quite adept at exporting, even under the current less than optimal conditions, their efforts could be even more productive were they to benefit from the integrated approach of an export trading company as contemplated by the various bills upon which we will comment today. Moreover, such experienced exporting companies have the potential to assist other smaller and/or new to export businesses by functioning as a part of a full service export trading company.

I. NATIONAL MACHINE TOOL BUILDERS' ASSOCIATION EXPORT PROMOTION ACTIVITIES

NMTBA and its member companies have devoted considerable me and effort to increasing exports.

NMTBA, on behalf of the American machine tool industry, devoting its own resources to the development and maintenance, international markets everywhere in the world. The Association s two people who spend virtually their full time overseas omoting United States machine tool exports with considerable sistance from the Department of Commerce.

NMTBA develops seminars and workshops to train our mbers' people on international financing, export licensing, or y other subject that will benefit a machine tool builder. We nduct market research to locate new and promising markets for dustry development. We have conducted twenty-four Industry ganized, Government Approved (IOGA) trade missions to help gain foothold in these new markets, and more are planned for 1980 d 1981. We sponsor foreign exhibitions so that our members ill have more opportunities to display their products overseas. addition, we often work in close conjunction with the Commerce partment on such activities as recruiting exhibitors for export omotion events such as catalog shows, video tape shows and chnical seminars. We organize reverse trade missions to bring reign buyers to our plants. And we bring large groups of reign visitors to the International Machine Tool Show in Chicago every two years. The Commerce Department has worked closely with us in the development and implementation of these programs, as have the commercial officers in our embassies and trade centers around the world.

IV. TAX TREATMENT OF EXPORT TRADING COMPANY

The tax provisions of S. 2757 have several purposes: (1) To insure that bank investments in export trading companies do not disqualify such companies from using Domestic International Sales Corporations (DISCs); (2) To make receipts from exports of services or export trade services eligible DISC receipts (that is, eligible for partial deferral of income taxation as is now extended to receipts from products sold internationally); (3) To require the Secretary of Commerce in consultation with the Secretary of Treasury to disseminate information on the utilization of DISC status and the likely advantages or disadvantages of doing so; (4) To modify certain Subchapter S regulations so as to permit small, closely held companies to pass through net losses in the first few years when start-up costs are likely to exceed income.

Addressing each of these provisions individually, we begin by focusing on # 1 of S. 2757 which would make clear that export trading companies with banks or other financial institutions as active ETC participants would not be disqualified from using DISCs because of such banking involvement. To do otherwise would to completely work at cross purposes with one of the essential lements of the export trading company legislation, S. 2718, eported by the Senate Banking Committee, namely the recognition f the vital role that banks and other financial institutions have o play as the financial fuel necessary to propel the export rading company. Although we appreciate that your first responsiility as members of the Senate Finance Committee is to carefully crutinize and analyze the provisions of S. 2757 as they would mpact on the tax laws and revenue concerns of the United States, e are also certain that you have studied and understand the xport related concerns which caused the Senate Banking Committee, s well as the sponsors of S. 2757 to make provisions for the ntegral involvement of financial institutions in export trading ompanies. Therefore, we urge your support of this provision hich would be of substantial assistance to the furtherance of . S. exports and of net benefit to the United States' economy enerally.

Secondly, S. 2757 would permit export trading companies to enjoy DISC treatment on all their income, including income derived from exports of services or export trade services. DISC treatment does not now apply to income derived from such services.

This is a very helpful change in the tax laws. We would suggest that consideration should also be given to both raising significantly the threshold for application of the incremental aspect of DISC and to reducing the average percentage of export sales used to compute the basis over which DISC treatment is applied. These additional improvements will enable small and medium sized exporters to improve their competitiveness in overseas markets. They also take appropriate cognizance of the role of inflation during the past few years in driving up the dollar value of many U. S. export sales.

We are aware that some have criticized the extension of DISC treatment to service related ETC income as being too costly from a revenue standpoint. Apparently the Treasury Department (based on 1978) data has computed the potential revenue cost of extending DISC benefits to "services produced in the United States" to be approximately $200 - $500 million. Similarly, Treasury has stated that DISC benefits extended to "export trade services" would potentially lead to a $100 - $200 million revenue loss.[1]

Apparently, however, the Treasury Department's computations of revenue cost were based on the erroneous premise that DISC benefits would be extended to the two types of service income of all DISCs. To the contrary, S. 2757 would extend DISC treatment of service income only to DISCs which would qualify as export trading companies. Thus, as the Banking Committee stated in its report on S. 2718 (which formerly contained tax provisions very similar to those of S. 2757, "to the extent Treasury's estimates are based on income from DISCs which would not qualify as export trading companies, the estimates necessarily overstate the actual revenue costs." Moreover, "since most DISCs are exporting, either solely or principally, the goods or services of a parent or affiliate, the number of present DISCs which would qualify as export trading companies is likely to be relatively small."[2]

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[1] U.S., Congress, Senate, Export Trading Companies, Trade Associations, and Trade Services, S. Rept. 96-735 to Accompany S. 2718, 96th Cong., 2d Sess., 1980, p. 18.

Finally, we strongly agree with the conclusion that "[i]f there is any significant revenue loss directly attributable to the tax provisions, it will be because export trading companies succeed in significantly expanding U. S. exports, which means additional revenue is being produced through additional exports."

Thirdly, we applaude the sponsors of S. 2757 for their recognition of the important role that information plays in the stimulus and development of international trade. We, therefore, commend the authors of S. 2751 for requiring the Assistant Secretary of Commerce, in cooperation with the Director of the Internal Revenue Service, to disseminate to exporters and export trading companies information on how to form and use DISCs.

Additionally, § 2 of S. 2757 would amend Subchapter S of the Internal Revenue Code to permit an export trading company to qualify for the special provisions of that Subchapter without limiting the foreign source income of such a trading company to less than twenty percent per annum. The logic of such a modification for companies whose raison d'être is to engage in foreign trade seems obvious.

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[2] Ibid.

Finally, § 3 would expand the current Subchapter S eligibility requirement to permit shareholders in companies eligible to use Subchapter S to be not more than fifteen companies, if the companies are each owned by not more than fifteen individuals.

We would recommend such changes as being appropriate and would urge their incorporation in this draft legislation. Although the administration, in contemplation of a more general modification of Subchapter S requirements, has recommended that this legislation not change these regulations, we believe that a change specifically directed to the needs of the export trading companies authorized by this legislation would not be inappropriate at this time.

V. CONCLUSION

In conclusion, we commend the sponsors of S. 2757, as well as the sponsors of the Banking Committee's legislation, S. 2718, for their legislative initiative in the area of export trading companies. They have demonstrated that they understand, and are willing to enhance through concrete proposals, the vital role that exports play in the overall strategic and economic well-being of the United States.

Although we have not specifically directed these comments to the details of the broader export trading company bill, S. 2718, we feel it important to briefly emphasize that the expansion of currently permissible activities under Webb-Pomerene to include services in addition to goods is of vital important if the U. S.

is to remain an aggressive and effective competitor in the ever expanding global economy. Additionally, clarification of the antitrust laws in this area, specifically those concerning which government agencies will be empowered to enforced such laws, will remove the legal uncertainties which heretofore have posed significant, and for many insurmountable, barriers to active involvement in the export market.

As we have stated, by restructuring the contours of export trading company activities, and providing appropriate tax regulations S. 2718 and S. 2757 working together will provide the vehicle for increased export activity. We believe that the combination of these two elements is extremely vital to the success of the export trading company concept.

Additionally, the extension of Eximbank loans to such trading companies as provided for in S. 2718 is also an important concept which merits attention in comprehensive export trading company legislation.

Finally, we thank this Subcommittee for affording us the opportunity to relate the experiences of the U. S. machine tool industry in the export market. We believe that the proposals contained in the bills we have addressed today, in conjunction with the improved export administration controls, and Executive Branch international trade reorganization plan will do much to encourage and promote overseas trade by both experienced and new exporters.

June 24, 1980

STATEMENT OF HARRY L. DITTY PRESIDENT OF KRAUSE MILLING COMPANY ON S. 2757, A BILL TO ENCOURAGE EXPORTS AND THE EXPANSION OF EXPORT TRADE SERVICES BY PROVIDING FOR SPECIAL PROVISIONS ON TAXATION OF EXPORT TRADING COMPANIES, BEFORE THE SENATE FINANCE COMMITTEE

Mr. Chairman, I am pleased to have the opportunity to testify before your committee. I am Harry L. Ditty, President of Krause Milling Company of Milwaukee, Wisconsin. In addition to our headquarters in Milwaukee, we have producing facilities in West Milwaukee, Wisconsin, St. Joseph, Missouri and Dodge City, Kansas. We are a small business with some 435 employees, which has considerable experience in attempting to develop commercial sales in export markets, as well as a long history of supply of blended foods to the P.L. 480 program. Our company currently exports in excess of 25% of our total production.

While many of the governmental programs that might be undertaken to assist business in expanding export trade apply equally to firms of varying size, our perspective is that of the smaller company possessing limited resources for export development and able to assume limited commercial risk. It is, in our opinion, in these two areas of market development and commercial risk that many of the causes may be found for the limited export sales penetration by smaller business enterprises.

When it embarks, for the first time, upon a program of export market development for products it can produce, the smaller firm often finds itself facing some bewildering obstacles. The firm is unfamiliar with the laws, market, customers, and channels of distribution within the targeted export market. The firm lacks established foreign production or sales facilities which can be utilized as a bridgehead for market diversification and penetration into unfamiliar areas. Further, the small firm often has limited financial resources and/or background knowledge from which to acquire sophisticated on-site development assistance.

If the smaller company is successful in developing a significant market potential, it finds itself vulnerable to commercial risks that are, in many cases, unanticipated and which may be of such perceived magnitude as to cause the fledgling exporter to cease selling efforts. Examples of this type of debilitating risk experienced by our own firm over past years includes sudden unannounced tariff increases while product is enroute to a foreign destination, misrepresentation of agreed-upon terms of sale by untested foreign middlemen, and necessity to accept commercial risk beyond that afforded by available credit protection instruments. These examples by no means exhaust incidents of our own experience. Their effect on the small firm newly embarked upon export development may, however, be to cause them to conclude that their total efforts are better directed to domestic operations.

S. 2757, and the Export Trading Companies and Associations proposal (S. 2718), and the Small Business Export Expansion Act (S. 2620) all address problems facing smaller companies. We fully endorse all three bills but in order to address the difficulties discussed above and stimulate export development by less sophisticated firms, we would like to suggest for your consideration additional provisions that our experience indicates to us would be more beneficial. First among these would be the granting of tax credits for verified export development expenses. Regardless of the commercial approach to export markets, any firm desiring to establish a continuing and growing foreign market for its products must engage its own personnel in a degree of on-site developmental activity. Such activity is very expensive and even worse, has no promise of ever generating a return to the company undertaking the program. (As an aside, Krause Milling Company's current costs for developmental work in Africa run at $7,000 for one man for one month.) Permitting full tax credit for such activity would provide necessary stimulus to needed market development by those firms unable to justify or to afford this expensive activity. The credit so as to not exacerbate an already complicated budget balancing process should probably be limited to a maximum dollar amount or alternatively structured so as to be available only to businesses with gross sales below some dollar figure.

Once a commercial export sales channel has been established, a period of vulnerability must be overcome if it is to achieve mature free-standing status. This is the period when initial volumes are low, service costs are high, and unanticipated product or packaging alternations must be made. While always an expensive activity, this shake-out period conducted across oceans and language barriers can become so expensive as to cause the smaller firm to withdraw its sales activity. To address this potentially fatal obstacle to export sales growth, I recommend that tax relief be considered which focuses on this embryonic period of sales growth. Such tax relief should provide for a reasonable (but not overly long) period of time after initial sales in which to generate self-sustaining sales volumes. A period of perhaps two years would be realistic and appropriate.

Our second recommendation is more specifically directed towards P.L. 480 exporters such as ourselves. As you know, P.L. 480 is designed to provide emergency food relief for humanitarian purposes. Presumably, food is donated or financed on favorable terms by the Commodity Credit Corporation only in instances where commercial sales are not a real possibility because of the financial weaknesses of the recipient country. To some degree our experience shows that some commercial sales might be completed if we were able to place marketing personnel in the recipient countries.

The U.S.D.A. and State Department field officers are not commercial developers, and at the current time neither P.L. 480 suppliers nor the recipient countries have incentives to attempt to negotiate commercial sales. Such an incentive would exist for suppliers if DISC rules were expanded to include some portion of P.L. 480 sales to the government. We feel it is possible to limit this special treatment to small or intermediate-size businesses so that the revenue impact would be minimal. Additionally, the income tax savings attributable to this expanded

DISC treatment could be further limited to the amount of money used for qualified export development activity and phased out over the same two-year period mentioned previously.

Earlier in my comments I referred to commercial risk. We realize that your Committee may not have the appropriate jurisdiction, but do want to highlight the problem for the record. Many of the examples quoted from our own experience cannot be covered by existing insurance programs. Advance recognition of these risks can lead the decision-maker to conclude that the potential gain is not worth the risk. Failure to recognize the risk can result in a financial crisis to the small company experiencing such episodes. We recommend that the Senate attempt to provide for some form of commercial credit insurance directed specifically to small and intermediate-size firms. The U.S.D.A., Foreign Agriculture Service on June 8, 1980, published notice of a proposed export credit assurance program which contains an insurance proposal similar to what we envision. The U.S.D.A. program is, of course, limited to agricultural commodities.

In summary, Mr. Chairman, we have been very pleased by the developments in export-related legislation this year. We support expansion of the DISC provisions as a means of enhancing export market development for small business. Tax incentives, in our opinion, are the best way of making seed money available to small exporters for the purpose of developing new foreign markets.

NAFCU
National Association of
Federal Credit Unions
P.O. Box 3769
Washington, D.C. 20007
703/522-4770

June 23, 1980

The Honorable David L. Boren
United States Senate
440 Russell Senate Office Building
Washington, D.C. 20510

Dear Senator Boren:

The National Association of Federal Credit Unions -- the only national trade association exclusively representing the interests of our nation's Federally chartered credit unions -- shares the concern which you and many of your colleagues in the Congress have expressed regarding the condition of our nation's economy and our financial institutions system. Your proposal (S. 2646, which would establish "Save America" savings accounts) certainly merits the consideration of all those who share your alarm over the worsening economic condition of the country. I fully agree that we must encourage more saving and investment through well placed tax incentives.

The tax incentive formula proposed in S. 2646 complements the temporary tax exclusion provided by Section 404 of the "Crude Oil Windfall Profits Tax Act of 1980" (Public Law 96-223) very well. Your proposal would encourage capital formation and go far toward stimulating home mortgage and agricultural lending, while simultaneously encouraging individual thrift.

Senator Boren, on behalf of the members of the National Association of Federal Credit Unions, I would suggest one change in the definition of "qualified interest" as it presently is defined in your "Save America Savings Account Act of 1980". Rather than require that "the principal with respect to which the interest is payable...is used...for the purpose of making qualified loans," I recommend amending that provision to read, "principal with respect to which the interest is payable...is held on deposit at an institution authorized to make qualified loans." (See attached). Incorporation of this revised language into S. 2646 would result in three distinct benefits:

1) It would enhance the ability of our nation's 12,700 Federal Credit Unions, which received long-term mortgage lending authority in 1977, to attract a relatively stable pool of funds which they might then extend to their more than 25 million members in the form of home mortgage loans;

2) It would assist the depressed housing market by recognizing and establishing credit unions as alternative sources of home mortgage financing; and

3) It would make available to a substantially expanded segment of the population an obvious incentive to practice thrift.

Senator Boren, the "Federal Credit Union Act" defines a Federal credit union as "a cooperative association organized...for the purpose of promoting thrift among its members and creating a source of credit for provident or productive purposes." (12 U.S.C. 1752 [1]). Enactment of S. 2646, the "Save America Savings Account Act of 1980", with the modified definition of "qualified interest" suggested above, would greatly assist Federal credit unions in carrying out their statutory mandate to promote thrift and provide credit for productive purposes.

I ask that this letter be included in the official hearing record on S. 2646. If you have any questions regarding this or any other matter affecting Federal credit unions please feel free to contact NAFCU's executive vice president, Dick McConnell, or our director of government affairs, Bill Donovan, at 522-4770.

Sincerely,

John J. Hutchinson
President

An amendment to S. 2646, the
"Save America Savings Account Act of 1980"

On page 2, strike lines 23, 24 and 25 and insert:

"(B) is held on deposit at an institution authorized to make qualified loans.

Received
July 15, 80

NRECA NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION
1800 Massachusetts Avenue, N.W.
Washington, D.C. 20036/202-857-9500

July 14, 1980

Honorable Harry F. Byrd, Jr.
Chairman, Subcommittee on
Taxation and Debt Management
Generally
Senate Finance Committee
417 Russell Office Building
Washington, D. C. 20510

Dear Mr. Chairman:

On behalf of the National Rural Electric Cooperative Association, I respectfully request this letter be included in the hearing record on S. 2766, the Hydropower Development Act of 1980, held by the Senate Finance Subcommittee on Taxation and Debt Management Generally on June 24, 1980.

NRECA, the national service organization of more than 1,000 consumer-owned electric systems located in 46 states, supports S. 2766, the Hydropower Development Act of 1980. This legislation would permit the use of tax-exempt financing for the construction of hydroelectric power facilities. This type of Congressional encouragement will enhance the prospects for development of one of this Nation's most important renewable energy resources. S. 2766 would permit the rural electric cooperatives to provide their own long-term financing for hydro-generated electric power.

We need not advise the Congress of the urgency of providing additional electrical generating capacity. To quote from ELECTRIC POWER SUPPLY ... ISSUE OF THE 80'S, a joint report by NRECA and the National Rural Utilities Cooperative Finance Corporation, on page 15:

> "The industry projections of the trade publication, Electrical World, made in the fall of 1979 had also trimmed the projected growth in peak demand to an average rate of 3.9% for the 10-year period (1979-88).
>
> To meet even these revised projections, it will be necessary for the electrical industry to increase its total capacity from 517,000 MW, where it stood in 1977, to 765,000 MW in 1988 if it is to maintain reserve capacity of 20% to insure reliability. This is an increase of 248,000 MW of capacity.

For the rural electric systems the required increase in capacity in proportion to their present resources (13,700 MW) is undoubtedly going to be significantly greater than for the industry as a whole."

Hydroelectric facilities provide an environmentally safe, readily available method of generating electricity. Additional water powered generating development will serve to reduce our Nation's dependence on an uncertain supply and unpredictably priced foreign liquid fuel supply which endanger not only the U.S. domestic energy policy but also domestic economic security.

From Environmental Protection Agency data used during the discussion of the recently-enacted Windfall Profits Tax legislation (Public Law 96-223), the Senate-approved provision permitting use of tax-exempt financing for hydroelectric facilities would have saved 74,000 barrels of oil per day by the year 1990. Further, surplus water from such projects can be utilized for consumer and agricultural needs. Finally, President Carter, in his December 20, 1979 announcement of the "Small Community and Rural Development Policy" stated support for rural community development of local energy resources such as hydroelectric facilities.

Following are portions of two resolutions addressing this issue as adopted by the membership of NRECA at the February 1980 Annual Meeting held in New Orleans:

Financing for Hydro Generation -- We recognize the urgent need for the development of additional electrical generation utilizing renewable resources such as conventional and pumped storage hydroelectric generation with the resultant conservation of exhaustible mineral resources. This is an integral part of the President's energy package.

We also recognize that the cost of power from hydroelectric generation is not subject to the inflationary effects of fossil fuel costs; hence, the use of such generation reduces the magnitude of electric rate increases.

Amendments to the Internal Revenue Code -- In order to allow rural electric systems to construct the most efficient and low-cost generating facilities, we suggest the following changes to the Internal Revenue Code:

1. An amendment to permit rural electric systems to be classified as exempt persons according to the Internal Revenue Act so that public power districts, municipals, and G&T cooperatives can jointly plan and construct large electric generating stations through the issuance of tax-exempt securities; and

2. An amendment to permit rural electric systems to issue tax-exempt securities to finance facilities.

We appreciate your attention to this important proposed legislation.

Sincerely,

John Davenport

John B. Davenport, Jr.
Director
Government Relations

JBD:vs

Emergency Committee for American Trade 1211 Connecticut Ave Washington DC 20036 (202)659-5147 / 730 F[illegible] Ave NYC 10019 (212)5

Send TO FiNanc

July 10, 1980

The Honorable Harry F. Byrd, Jr.
Chairman
Subcommittee on Taxation and Debt Management
Committee on Finance
2227 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

I want to express the support of the Emergency Committee for American Trade (ECAT) for S.2283, S.2418 and S.2321. ECAT is an organization of 65 U.S. companies with extensive international business operations. In 1979 ECAT companies had worldwide sales of approximately $500 billion and they employed nearly 5 million workers.

International business competition is severe. From time to time our government makes it more difficult by imposing burdens on U.S. firms and their overseas subsidiaries that are not shared by our foreign competitors. One of these is the manner in which the U.S. government taxes the income of American citizens living and working overseas through Sections 911 and 913 of the Internal Revenue Code. These sections constitute a heavy tax burden. To offset these taxes, U.S. firms, in order to recruit and keep U.S. employees abroad, compensate their overseas American workers for the increased tax burden of Sections 911 and 913. These tax payments become a cost to U.S. firms of doing business abroad. In many instances, particularly in engineering, construction, exploration and other industries involving large numbers of workers, these added tax costs are enough to make the bids of U.S. firms non-competitive. Business is thus lost to foreign competitors whose governments as a rule do not impose taxes on the incomes of their citizens working overseas.

You undoubtedly are aware of the recent Chase Econometrics study of the economic effects of Sections 911 and 913. Among the principal findings were that their tax costs add from two to ten percent to the cost of U.S. goods and services; that the consequent reduction in U.S. competitiveness abroad results in a significant decline of about five percent in U.S. exports; and that this drop in U.S. exports will cost about 80,000 jobs and reduce federal tax receipts by more than $6 billion in 1980. Another significant finding of the study is that a high percentage of U.S. workers abroad are returning home because of the tax.

S.2283, S.2418 and S.2321 are each designed to either significantly alleviate or to remove the tax burden of Sections 911 and 913. We strongly support these bills and hope that their purpose will be accomplished through legislation at the earliest possible time.

Sincerely,

Robert L. McNeill

Robert L. McNeill
Executive Vice Chairman

July 11, 1980

STATEMENT OF
THE NATIONAL ASSOCIATION OF HOME BUILDERS
before the
SUBCOMMITTEE ON ON TAXATION AND DEBT MANAGEMENT GENERALLY
SENATE FINANCE COMMITTEE
UNITED STATES SENATE
on
TAX INCENTIVES FOR SAVINGS

On behalf of the more than 124,000 members of the National Association of Home Builders, I would like to take this opportunity to present our comments on two bills providing tax incentives for savings, S. 2646 (introduced by Senator Boren) and S. 2560 (introduced by Senator Nelson).

At the outset, we would like to commend Senators Boren and Nlson for recognizing the difficulty American families are now having in obtaining mortgage financing at interest rates they can afford. While interest rates are now retreating from their all time highs, our economists tell us they will never return to early levels. This means that despite the tremendous demand for housing we anticipate during the 1980's, it will continue to remain difficult for families to afford to purchase homes. Senator Boren's and Senator elson's bills both recognise this dilemma and provides a source of mortgage financing at interest rates greater

numbers of American families can afford. Attached is Resolution of policy by NAHB's Board of Directors.

Housing Finance Crisis in the 1980's

We are vitally concerned about the availability and cost of mortgage finance in the 1980's. The underlying demand for housing is very strong and will remain strong through the decade of the 1980's. Projections indicate that during the 1980's, 41 million Americans will reach the prime home buying age of 30. This compares with only about 31 million who reached that age during the 70's.

When combined with the number of families currently occupying substandard housing and the number of housing units removed from the market each year by demolition, disaster or other means, and additional 12.5 million to 14 million housing units could be needed during the next five years. This demand for housing would not even be met by a level production of 2 million units per year, which has traditionally been considered a "very good year" for housing. And any lower production will almost certainly result in increased upward pressure on home prices due to the simple facts of supply and demand.

The Current Housing Recession

Despite this tremendous need and demand for housing, housing starts are now at their lowest level since 1975. Privately owned housing units started in May, 1 1980 were at a seasonally-adjusted annual rate of 920,000 units; this is 49% below the rate of 1,801,000 for the year before, May 1979. This major slump in housing has had dramatic effects throughout the whole economy, touching on not only homebuilders and construction workers but also the suppliers of materials used in building houses. The 17% home mortgage interest rates prevelant only a few weeks ago, virtually eliminated all families from the possibility of purchasing housing.

Long Term Trends In Interest Rates

Interest rates are beginning to ease up, but for the foreseeable future, we believe they will remain at rates which will prevent many millions of American families from affording homes. Major changes are occurring in the cost and availability of mortgage finance. Many of these changes were precipitated by the Depository Institutions Deregulation and Monetary Control Act of 1980, which was signed by the President on March 31, 1980. The Act gradually phases-out Regulation Q, so that within six years there will no longer be any maximum ceilings on the interest rates which banks and thrifts can pay their depositors. While this is unquestionablly important to the depositors--it will mean a much higher cost of funds to the financial institutions which will be translated in much higher mortgage interest rates for housing consumers.

The actions of the Depository Institutions Deregulation Committee (which was created under the Act) speeded the process to eliminate Regulation Q. On May 28, the Committee essentially put a floor of 7 3/4% on interest payable on six Month Market Certificates, and a floor of 9 1/2% on 30 Month Market Certificates by Savings & Loan Associations. The U.S. League of Savings Associations points out that if thrifts are locked in to paying at least 9 1/2% interest on their savings deposits, they will not be able to make mortgage loans at interest rates below 11% or 11 1/2%. This means that during the decade of the 80's, mortgage interest rates may never drop below 11%. And as we have seen recently, they may rise sharply above that.

Effect of Double-Digit Interest Rates

What this means is that despite the overwhelming need and demand for housing, increasingly fewer families will be able to afford housing. Table II shows the effect of higher interest rates on housing affordability. Assuming a $65,000 houses, with a 5% downpayment, and a 30 year fixed rate mortgage. At 9 1/2% interest, the monthly principle and interest payment would be $519 and the annual income necessary to afford the house would be just ver $35,000. At 12 1/2% interest, the principal and interest payment jumps $140 a month, to $659.00, and the annual income needed to afford the house increases to almost $42,000. Assuming the same $65,000 house with a 5% downpayment, the increase in interest rate from 9 1/2% to 12 1/2% eliminates more than 4 million households from the ability to purchase that home.

Tax Incentives for Savers Bills

The bills introduced by both Senator Boren and Senator Nelson recognize that mortgage interest rates have been permanently ratchened to double-digit levels. They also recognize the importance of a strong housing industry to the nation's economy and the importance of enabling families to quality to purchase homes. We fully support the concept contained in both bills that a tax incentive be given to savings which will be used to provide mortgage loans at below market interest rates.

Of the two bills, we believe the approach taken in S. 2560 is preferable. First, the bill is directed exclusively towards providing mortgage finance for housing. Adequate housing is a necessity for all Americans, and we think it is appropriate to have an incentive specifically to assist families in purchasing homes. Shelter is not only a basic human need but homeownership is the top priority and goal of most American families. Allowing the deposit to be used for other purposes dilutes the effect on housing and could easily result in a short all of funds necessary to finance homes.

Secondly, we believe that in order to make this incentive work to its fullest and encourage the maximum amount of funding for mortgage loans, there should be no limitation placed on the amounts of money which can be deposited into accounts which are exempt from tax. The housing demand of the 80's will be substantially greater than even before--even the 70's. This will require a large amount of financing for home mortgages.

Finally, we are concerned about the interest rate limitations contained in Senator Boren's bill. The 7% cap on interest rates paid depositors and the 9 1/2% cap on mortgage interest rates certainly provide a pool of low cost mortgage funds. The problem is that in periods of rising interest rates the 7% deposit rate may not remain competitive with other tax exempt investments thereby resulting in disintermediation and a shortage of mortgage funds. Again, Senator Nelson's bill which contains no such restrictions could be preferable.

I appreciate this opportnity to present our views and comments and hope that they are beneficial to the Committee in its deliberations.

National Association of Home Builders
15th and M Streets, N.W., Washington, D.C. 20005
Telex 89-2600 (202) 452-0200

STATEMENT OF

THE NATIONAL ASSOCIATION OF HOME BUILDERS

before the

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

SENATE FINANCE COMMITTEE

UNITED STATES SENATE

on

TAX INCENTIVES FOR SAVINGS

July 11, 1980

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I appreciate this opportunity to present our views and comments nd hope that they are beneficial to the Committee in its delibera- ions.

NAHB RESOLUTION

May 19, 1980
Washington, D.C.

Special Committee on Taxation

TAX INCENTIVES FOR SAVINGS

WHEREAS, housing affordability is dependent on a supply of money at prices which Americans can afford to pay for home ownership and rental housing; and

WHEREAS, mortgage rates are dependent on the cost of money, in the form of deposits, to the lending institutions,

NOW, THEREFORE, BE IT RESOLVED that the National Association of Home Builders seeks adoption of legislation which will be effective in increasing the supply of savings and reducing the rates of interest paid on residential mortgages by giving tax free treatment to all interest earned on savings deposits which are to be used for residential mortgages.

BOARD OF DIRECTORS ACTION: APPROVED

Table I

AFFORDABILITY OF HOUSING

Based on a 30 year term, $60,000 mortgage

terest te	Payment	Expenses[1]	Annual Income Needed to Afford[2]	Number of Families Who Can Afford	Percent of Families Who Can Afford
	$483	$215	$33,504	11,786,000	20.6%
	527	215	35,616	10,528,000	18.4
	572	215	37,776	9,212,000	16.1
	617	215	39,936	7,896,000	13.8
	664	215	42,192	6,523,000	11.4
	711	215	44,448	5,207,000	9.1
	758	215	46,704	3,833,000	6.7
	807	215	49,056	2,403,000	4.2
	856	215	51,408	1,831,000	less than 3.2%
	904	215	53,712		

Insurance, taxes, utilities

assumes 1/4 of income goes total housing payment

OURCE: NAHB Economics Division

STATEMENT OF JOSEPH S. WARD, PRESIDENT, AMERICAN SOCIETY OF CIVIL ENGINEERS BEFORE SENATE FINANCE COMMITTEE, JUNE 26, 1980.

Mr. Chairman, as President of the American Society of Civil Engineers I do appreciate the opportunity you have afforded the Americans working overseas by your willingness to hold hearings on the effect of taxation on international competitiveness of U.S. firms.

I personally am convinced that the alterations in the Internal Revenue Code that have resulted from Congressional action and court rulings have had a devastating effect on the potential for international trade. I had a feeling that this was true. I have to admit, Mr. Chairman, that I am no expert. Persons working for my firm, Converse, Ward, Davis Dixon, of Pasadena, California, have found life harder and harder overseas since the passage of the 1976 Tax Act. I find the same to be true as I talk to officers and employers of other American firms with overseas contracts.

Telling evidence of the magnitude of the damage that has been done to the trading position of the United States vis-a-vis that of other countries was what was needed. A respected source, Chase Econometrics, has recently produced just such information for the U.S. and Overseas Tax Fairness Committee. The Chase study, Economic Impact of Changing Taxation of U.S. Workers Overseas, is laden with data that are so glaring in their impact on the U.S. worker and his employer, that Congress must act.

It is clear that the Internal Revenue Service does not find the Chase study convincing. I am deeply sorry to have read press reports on the comments made in testimony and less formally by high officials of the IRS.

As the Chase study substantiates, the worst pinch for the American worker overseas--and many of them are civil engineers-- comes when they are assigned to low-tax developing countries, such as those of the Middle East. The practical result of an increased bite of Uncle Sam on the U.S. worker and the American firm has been that numbers of them are less willing and less able, for economic reasons, to compete for overseas contracts. At the very time that oil-rich countries are benefitting from the higher and higher prices for exported oil, the United States, one of the chief purchasers in the world, is in a weakened position to improve that trade imbalance through overseas work.

Obviously, Mr. Chairman, the tragedy is felt much more personally by the engineer himself. As he returns to the United States, he finds a different job climate here. He had the know-how and the commitment to work overseas, often in extremely unhospitable environments. However, his firm may have been unwilling or unable to pay tax differential on his salary and "benefits." As a result, his own take-home pay may have shrunken as the squeeze became more evident. Interestingly, the overseas "benefit" as considered by IRS are to most, necessities on the domestic front: i.e. decent housing, schooling, protection from rampant inflation, etc.

PACIFIC NORTHWEST GENERATING COMPANY
8383 N.E. SANDY BLVD., SUITE 330
PORTLAND, OREGON 97220
(503) 255-7248

TESTIMONY OF DAVID E. PIPER
GENERAL MANAGER OF THE
PACIFIC NORTHWEST GENERATING COMPANY
ON
THE HYDROPOWER DEVELOPMENT ACT OF 1980
(S.2766)

SUBMITTED TO
THE SENATE FINANCE SUBCOMMITTEE
ON
TAXATION & DEBT MANAGEMENT GENERALLY

July 8, 1980

Mr. Chairman and Members of the Subcommittee:

My name is David E. Piper. I am General Manager of the Pacific Northwest Generating Company, a non-profit, cooperative supplier of wholesale electricity to 18 rural electric distribution systems in the Pacific Northwest. Through these 18 member systems, PNGC serves over 130,000 consumers, more than 60 percent of the total rural electric load in our region.

PNGC was created several years ago as a generation and transmission cooperative to meet these members' future wholesale electric energy requirements. Current demands are met by the federal Bonneville Power Administration. After June 30, 1983, however, BPA will not be able to ensure sufficient power supply for its customers' additional demands and it will be PNGC's responsibility to provide the additional resources needed by our member systems. Assuming critical water conditions, we project large resource deficits through the end of this decade. As early as 1983, we are projecting our combined member deficit to be about 100 average megawatts.

To prevent the power shortages that would result from these deficits, PNGC is pursuing a broad range of resource options. PNGC has purchased a ten percent share in Portland General Electric's coal-fired, No. 1 Boardman plant in eastern Oregon, which will provide approximately 50 megawatts to our members. We also are studying a variety of other electric power generation options, including wind generation, cogeneration utilizing wood mill waste and garbage for fuel, as well as additional participations in other thermal generation plants.

To provide the additional needed resources soon enough, however, PNGC must limit its options to new resources having as short a lead time as possible. Potential new resources that utilize unproven technologies, require lengthy environmental studies or take a dozen years to complete would not be on line in time to head off our projected deficits.

Hydroelectricity, especially small hydroelectric projects that utilize existing dam structures, have emerged as our best option for reducing these deficits. The technology behind hydroelectricity long ago was proven sound. High fuel costs would be avoided. Operating costs would be low. Environmental impacts would be minimal. The resource is renewable and available on the domestic front. The highest cost in developing hydroelectricity is the capital cost of constructing the facilities, and Senator Gravel's bill could alleviate some of those costs. According to a study prepared by the U.S. Army Corps of Engineers, the nation could increase its hydroelectric capacity by five to ten times, if all potential hydroelectric sites were fully developed. In the Pacific Northwest, hydroelectricity could help forestall future power shortages that are almost a certainty.

In the past six months, PNGC has undertaken studies for a small hydroelectric development program involving 15 projects, capable of producing approximately 80 average megawatts. We currently are in the process of applying for preliminary permits from the Federal Energy Regulatory Commission and feasibility study loan funds from both the Rural Electrification Administration and the Department of Energy.

PNGC's financing options for construction could be supplemented through S.2766, which would allow our cooperative tax-exempt financing of such hydroelectric projects. As the law currently stands, this privilege is enjoyed only by publicly-owned utilities. The decision to limit the option to public utilities was made when fuel for generation was inexpensive and when it was not imperative that the country's renewable resources be developed.

Legislation limiting tax-exempt financing to "qualified" projects is an impediment today to many who wish to develop hydroelecricity, however, at a time when the availability and cost of other fuels is of crucial importance. I feel that Senator Gravel's bill to amend the Internal Revenue Code of 1954 is laudable, and I strongly urge that the Subcommittee give it serious consideration.

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MEMBER SYSTEMS
PACIFIC NORTHWEST GENERATING COMPANY

Member System Location	Manager	Consumers Served
Benton Rural Electric Assn. Prosser, Washington	Joe Chiara	7,881
Big Bend Electric Co-op, Inc. Ritzville, Washington	Byron Wagner	5,616
Blachly-Lane County Co-op Eugene, Oregon	Dale Swancutt	2,484
Central Electric Co-op, Inc. Redmond, Oregon	Lane Powell	10,192
Clearwater Power Company Lewiston, Idaho	George King	6,810
Columbia Rural Electric Assn. Dayton, Washington	Clark Brewington	2,350
Consumers Power, Inc. Corvallis, Oregon	John Meyse	12,992
Coos-Curry Electric Co-op Coquille, Oregon	Bill Cook	10,549
Douglas Electric Co-op, Inc. Roseburg, Oregon	Howard Crinklaw, Jr.	6,983
Inland Power & Light Co. Spokane, Washington	Vince Slatt	17,726
Kootenai Electric Co-op, Inc. Hayden Lake, Idaho	Mike Fox	6,989
Lane Electric Co-op, Inc. Eugene, Oregon	Rick Newland	9,084
Lincoln Electric Co-op, Inc. Davenport, Washington	Boyd Ressel	1,824
Lower Valley Power & Light Afton, Wyoming	Boyd Parker	9,856
Midstate Electric Co-op, Inc. LaPine, Oregon	Bob Patrick	7,185
Orcas Power & Light Company Eastsound, Washington	Bob Scharnhorst	5,158
Raft River Rural Electric Malta, Idaho	Golden Gardiner	2,230
Umatilla Electric Co-op Assn. Hermiston, Oregon	Russ Dorran	7,644

Source: 1978 REA Bulletin 1-1
July 8, 1980

SUBMITTED STATEMENT OF THE AMERICAN FEDERATION OF LABOR & CONGRESS OF INDUSTRIAL ORGANIZATIONS FOR THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE COMMITTEE ON FINANCE ON TAXATION OF EXPORT TRADING COMPANIES, S. 2757

July 17, 1980

The AFL-CIO opposes S. 2757, which would widen the Domestic International Sales Corporation (DISC) loophole to include a wide range of "service" industries, banks and financial institutions. The bill would also weaken some of the requirements that "small business" or subchapter S corporations must meet in order to maintain their exemption from the corporate income tax.

We oppose S. 2757 for three basic reasons:

First, S. 2757 in the name of export promotion widens a tax loophole that has consistently shown that its cost has far outweighed any benefits. The estimates of tax liability reductions are $300 million to $700 million a year on top of the $1.4 billion current cost of DISC. But this is undoubtedly a conservative estimate. The list of "services" and "export-related services" industries (as defined in Section 103(a) of the companion bill, S. 2718) suggests that the cost may be far greater since "services" can include a wide open range of activities from training to legal work to warehousing. (See attached list from Section 103(a) of S. 2718 for definitions of "service" and "export related services" as S. 2757 Section 101(b)(3) provides.)

Furthermore, as in the basic DISC legislation, there can be no assurance that exports of such services would result from the tax break or that the measure would not simply provide a "free ride" for multinational banks, insurance companies, lawyers, and warehouse operators who would get an added tax break for continuing to do what they are currently doing.

Second, in our view, banks and other financial institutions which invest in an export trading company should not be allowed to be a Domestic International Sales Corporation (DISC). The May 15 Senate Banking Committee Report of the companion bill, Export Trading Company Act of 1980, S. 2718, for example, details the importance of measures needed to assure that certain limitations on banking investments are continued. The Report provides a detailed basis for caution in efforts to end or blur the traditional 100-year-old separation between banking and commerce. At a time when banks and commercial enterprises in the United States are claiming capital shortages it is unrealistic to push a proposal that will result in a further competition for funds and diminution of capital for productive investments.

Thus by allowing banks to control Export Trading Companies and providing them with still another tax benefit, risky ventures are encouraged and the reach of the banks is extended to exports.

This bill, therefore, adds to the nation's financial risk. S. 2757 encourages financial institutions not only to be part of the commerce the banks are responsible for financing, but also restructure their operations for an even greater tax advantage. This is too great a burden to place on the U.S. monetary structure.

Third, to make the subchapter S corporations, which also qualify as export trading companies, exempt from their normal requirements, makes a mockery of those requirements. Under current law, subchapter S corporations or "tax option corporations" are generally limited to 15 individual shareholders. They are specifically prohibited from having corporate shareholders and cannot have more than 80 percent of their gross receipts from sources outside the U.S. The bill would eliminate both those requirements. Additional tax incentives to promote foreign source income and investment are, in our view, contrary to efforts needed to reindustrialize and revitalize America.

The AFL-CIO believes that expanding exports are important to the nation's health and many industries, including those that provide services, need and deserve the help of the U.S. government in an increasingly complicated international trading world. However, tax gimmicks like DISC or inappropriate exemptions from specific safeguards in U.S. tax law will not accomplish that objective. Rather, they will add complications and divert funds from programs that could produce desirable and demonstrable results. We, therefore, urge this Committee to reject S. 2757.

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ATTACHMENT

Sec. 103 (a)

(3) the term "services produced in the United States" includes, but is not limited to accounting, amusement, architectural, automatic data processing, business, communications, construction franchising and licensing, consulting, engineering, financial, insurance, legal, management, repair, tourism, training, and transportation services, not less than 50 per centum of the sales or billings of which is provided by United States citizens or is otherwise attributable to the United States;

(4) the term "export trade services" includes, but is not limited to, consulting, international market research, advertising, marketing, insurance, product research and design, legal assistance, transportation, including trade documentation and freight forwarding, communication and processing of foreign orders to and for exporters and foreign purchasers, warehousing, foreign exchange, and financing when provided in order to facilitate the export of goods or services produced in the United States;

(emphasis supplied)

General Motors Statement on S.2783 to the Energy and Foundations Subcommittee of the Senate Finance Committee

General Motors appreciates the opportunity to submit this statement for the record of the hearings on the bill, S.2783, sponsored by Senators Malcolm Wallop and Jake Garn.

We support passage of the bill which is designed to broaden the definition of energy property used to determine application of the 10 percent energy investment tax credit to include expenditures for the property needed to upgrade oil shale before it is refined.

General Motors for some time has advocated adoption of supply-oriented national energy policies, including government incentives, to encourage the development of alternate sources of energy. In our view, the energy investment tax credit approved by Congress in 1978 was an important step in encouraging investment in synthetic fuels.

We do not understand, however, why oil shale production was given less favorable treatment than other alternative fuels, such as coal gasification, liquefaction, solar, ocean thermal, wind and biomass for which a much larger percentage of the project costs qualify for the energy investment tax credit. We support S.2783 because it will correct this inequity and insure an evenhanded application of the tax credit.

Because of the great quantities of oil shale available in the U.S. and the extensive technological and scientific work that has been done on developing ways to mine and upgrade oil shale, we believe oil shale has a crucial role to play in providing substitutes for imported oil. Oil shale has a potentially important role to play in providing fuels suitable for use in the transportation sector. Indeed, as we attempt to rank the usefulness of alternate fuels in the transportation sector, we believe gasoline and diesel fuel from oil shale appear to be the most likely supplement to petroleum. Hydrogenation of kerogens, found in oil shale, produces a synthetic crude product which can be refined to yield gasoline and diesel fuel. The Wallop-Garn bill would extend the energy investment tax credit to include this hydrogenation process.

We appreciate the opportunity to submit these comments and urge early passage of S. 2783.

7/10/80

STATEMENT OF THE FEDERAL FINANCE COMMITTEE
COUNCIL OF STATE CHAMBERS OF COMMERCE
to the
SENATE COMMITTEE ON FINANCE
July 24, 1980

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The Federal Finance Committee of the Council of State Chambers of Commerce met on July 11 to consider the recommendations it should make to the Senate Committee on Finance in connection with its objective of developing " a responsible targeted anti-inflationary tax cut to take effect in 1981." Our committee's views and recommendations are herewith submitted. Under our normal procedures our statement would also be submitted on behalf of member state organizations in the Council which had endorsed the committee's recommendations. On this occasion, however, time limitations precluded the obtaining of these endorsements.

We commend the Committee on Finance for its decision to hold these hearings to determine the kind of anti-inflationary tax reduction legislation that it should recommend to the Senate.

While the time available for congressional action on tax legislation in the remaining weeks before the November election is obviously much too short for extensive tax revision, we do believe enactment of a limited measure is possible and practicable. But the desirability of enacting such a limited tax bill to be effective next January would depend on its purpose. A tax cut weighted to encourage consumption would only add to inflationary pressures and expectations. On the other hand, tax revision to encourage capital formation would meet the most pressing needs of the economy, namely, the creation of new jobs and improvement of productivity. Accordingly, we would oppose a consumption based tax cut and urge enactment of a measure to encourage savings and productivity improvement.

The Balanced Budget Issue

It appears that the American public has become convinced that balancing the Federal budget is essential to bringing inflation under control. The Congress, too, adopted this stance in its first concurrent resolution on the budget for the 1981 fiscal year. We certainly concur with the view that balancing the budget is one important means of controlling inflation but we do not believe it is desirable under all economic conditions. To do so under circumstances such as the current recession, with slow growth expected after it bottoms out, would tend to deepen and prolong the recession. The budget result could be even greater deficits over the next few years. With the right kind of tax relief coupled with effective spending control, a first year increase in the deficit would soon be offset by rising revenues from growing economic activity and a near-term surplus would be possible.

It is on the basis of support for a policy of balancing the budget over the business cycle that we urge enactment of two revisions in business taxes to be effective January 1, 1981.

Capital Formation Legislation Needed Now

One of the business tax revisions that we recommend for enactment now is replacement of the present "useful life" concept of depreciation with a capital recovery allowance system. This new system would be applicable to depreciable property acquired after December 31, 1980. Legislation that would accomplish this change for recovery of capital investments is provided in S. 1435, which now has the sponsorship of 53 Senators. Their bill, commonly referred to as the 10-5-3 legislation, establishes three classes of depreciable property as follows:

Class I - Ten-year cost recovery for buildings and their structural components, with residential rental property being excluded.

Class II - Five-year cost recovery for machinery, equipment and other tangible property except for property in Class III.

Class III - Three-year cost recovery for automobiles and light trucks, to the extent of the first $100,000 investment per year.

Under S. 1435 property will become eligible for cost recovery when it is paid for, or when it is placed in service, whichever is earlier. All or part of the recovery allowance for a year may be deducted in that year, with any unused portion being carried forward to a future year. Upon sale of an asset, the portion of any capital gain which represents prior capital cost recovery is taxed as ordinary income.

The second business tax revision we urge for enactment now is a reduction of at least two percentage points in the present 46% corporate income tax rate on income over $100,000.

During the past year and a half the economic leadership of the present administration have duly noted and expressed concern about the poor productivity growth record of the American economy in recent years. They have also pointed to the need for encouraging capital investment as the basic means of improving productivity. These expressions of concern and need have come from the Council of Economic Advisers, former Secretary of the Treasury Blumenthal and his successor, G. William Miller.

The Congressional Joint Economic Committee has not only concurred with these administration concerns but has stated its views more strongly. In the Summary of its August 1979 Midyear Report the Committee stated -

> America's dismal productivity performance is an important cause of the nation's stagflation... the solution lies in the adoption of longer-run policies aimed at expanding the supply of the economy; that is, at expanding the nation's productive potential in a manner that raises dramatically the growth of American productivity... When America's growth in productivity is compared with those of other major industrialized countries, our record is the least enviable. Growth in productivity since World War II has lagged behind the rates posted by every one of our major trading partners.

The Joint Committee's comments are fully as applicable to our economy today as they were when made a year ago. We submit that a start should be made now toward getting our economy on the track of productivity improvement. Enactment of the capital recovery legislation and corporate rate reduction that we recommend would be a major move toward that objective. As we see it, this would be the most productive tax legislation that Congress could now enact within a prudent fiscal policy.

To the extent that the Congress should decide to provide tax relief for individuals, such relief should be designed to reduce the bracket creep effect of inflation and to encourage savings. In this latter connection, an early objective for all individual income should be a top rate not in excess of 50%. Other tax revision objectives for enhancing savings and investment should be lower capital gains tax and relief from double taxation of dividends.

Spending Control - The Prudent Fiscal Policy Imperative

Along with the business tax revisions that we propose for enactment now, we urge enactment of a measure which would automatically set a ceiling on total expenditures in the fiscal year. It is an imperative for the prevention of recurring large budget deficits as the economy recovers to satisfactory growth levels. Moreover, an automatic restraint on spending growth, such as we propose, would make budget allowance in a short time not only for relief of individuals from inflation caused bracket creep but also for enactment of provisions such as we recommend to enhance saving and investment.

An appropriate automatic spending limitation would be a stated percentage of the gross national product. Such percentage limitation could be incorporated as a new provision in the Congressional Budget Act as is provided in S. 34. In consideration of the percentage of GNP that would be an appropriate limitation for expenditures in the period ahead, it is useful to review the ratio of expenditures to GNP in past years. In the years between the Korean and Vietnam wars, 1954 through 1966, Federal expenditures never reached 20% of GNP and in seven of these years they were less than 19%. Coincidentally, this was a period of real price stability compared to the inflation record since 1966.

But since 1966 expenditures have exceeded 20% of GNP in every year except for 1974. In the five years 1975 through 1979 they exceeded 21%, with 1975 and 1976 spending exceeding 22%. In his budget for 1980 the President noted that outlays as a percentage of GNP would be 21.2%, slightly lower than in 1979, and he stated that the percentage would decline further to 21.0% in 1981 and 20.3% in 1982. The January budget document for 1981, however, placed the percentage at 22.4% in 1980 and 22.3% in 1981. Both of these percentages are likely to be higher when the final results are in for these years.

Under S. 34 outlays in the first year would be limited to 21% of GNP and the ceiling would be reduced to 20% in the second year, 19% in the third year, and 18% in the fourth year. The limitation could be waived by a two-thirds vote in each House. We support the limitation approach of S. 34 but with some difference. On a comparable basis, our proposal would set the limit at 21% for the first year but the limitation would be reduced in the second and subsequent years by 0.5 percentage point below the prior year's level until the ceiling becomes 19.0% where it would remain.

Adoption of our spending control proposal would pave the way for noninflationary economic growth in the period ahead. It would permit enactment during the next few years, and within a prudent fiscal policy, of additional saving and investment enhancing tax revisions beyond the two we recommend for enactment now. We submit that such tax revisions would have far greater beneficial impact on the economy and for the public generally than would additional spending that would be forsaken.

George S. Koch, Chairman
Eugene F. Rinta, Consultant
Federal Finance Committee
Council of State Chambers of Commerce

STATEMENT OF THE U.S. LEAGUE OF SAVINGS ASSOCIATIONS BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE SENATE FINANCE COMMITTEE REGARDING S.2560 AND OTHER TAX INCENTIVE PROPOSALS

The U.S. League of Savings Associations welcomes this opportunity to submit written testimony on the subject of tax incentives to encourage savings, particularly Senator Nelson's bill, S.2560, which would exclude from taxation interest earned on deposits used for residential mortgage lending purposes.

Rampant inflation and ever increasing personal income taxes have produced a devastating impact on the rate of personal savings and capital formation in this country. As the rate of personal savings plummets, investment lags and productivity suffers. At present, U.S. economic productivity is virtually at a standstill. Consider the following:

Since 1976:

- Consumer prices have increased by 43%.
- Personal income taxes have increased by 67%.
- The personal savings rate has been cut in half, from 7% to 3.5%.
- Productivity measured by an index of output per hour, has increased by only 1/2% per year.
- The average annual ratio of capital investment as a percent of output is lower in the U.S. than in any other major industrial nation.

The U.S. has been delinquent in providing a suitable tax environment for encouraging savings and, as a result, our economic productivity has suffered. Furthermore, housing, which is most reliant on personal savings, has been particularly hard hit by chronic inflation and increasing individual tax burdens. The relationship between savings flows and housing is direct; weak savings flows equal reduced mortgage lending. S.2560 would not only boost savings by authorizing a tax-exempt account, but it would increase available mortgage credit by requiring that this tax-free savings be used only for residential mortgage lending purposes. The U.S. League of Savings Associations strongly endorses these objectives contained in the Nelson bill.

However, if a tax incentive is to provide the necessary stimulus to correct our critical savings shortfall, we believe it must be broadly based. All sectors of our economy, not just housing, need additional capital. Consequently, any tax incentive legislation must be a general savings stimulant rather than targeted if it is to receive broad support and a chance for rapid enactment.

Herein lies our concern. S.2560 is an ambitious program with substantial loss of tax revenue to the Treasury -- so much so that the savings incentives necessary for capital formation by other sectors may be squeezed out. Special assistance can certainly be justified to supplement savings flows to particular sectors of the economy, particularly first-time home buyers. However, in view of our widespread savings shortfall, encouraging savings incentives that benefit all types of capital formation should be our first order of business. Savings and loan associations, the nation's primary source of mortgage credit, are confident of attracting their share of new savings dollars to speed recovery of the beleaguered U.S. housing industry when a tax incentive is finally enacted.

Two tax incentive plans which would benefit all sectors of our economy by encouraging individuals to increase their systematic long-term savings include:

1) The Savings and Investment Act of 1979 (S.1964)
This bill, introduced by Senator Heinz, creates a tax-deferred rollover for reinvested interest, dividends and capital gain from interest-bearing savings accounts, stocks and bonds. The plan encourages long-term systematic savings, limits revenue loss by requiring taxes to be paid when savings are withdrawn, permits interest compounding and allows savers to continue to manage their investment portfolio.

2) A Universal IRA Proposal
This plan brings together numerous individual retirement account improvements contained in legislation already introduced. The Universal IRA provides that (a) individuals may establish a separate retirement account even if they are covered by existing retirement plans and deduct the contributions to the plan, or (b) maintain existing company plans and receive a tax deduction for contributions to the plan; and (c) provides full coverage of houseperson under the retirement plan based upon the working spouse's earnings. The Universal IRA proposal has many advantages. It would:

(i) provide a large enough savings incentive to substantially increase net new savings for a wide range of taxpayers (since taxation is deferred on the total contribution);

(ii) provide the greatest increase in long-term savings of any tax incentive plan while providing a necessary increase in funds available for retirement;

(iii) help to take some of the pressure off the Social Security System by augmenting an individual's private contribution to retirement; and

(iiii) correct the inequities imposed on retirement security by unanticipated inflation.

Like the tax-derred rollover, the Universal IRA would channel savings to all sectors of the economy. But perhaps the Universal IRA's most important feature is that it provides substantial aid to persons who wish to accumulate retirement income. And since many predict our current Social Security System will prove grossly inadequate to meet the heavy retirement demand at the end of this century, an effective supplemental retirement program will be absolutely essential.

The U.S. League firmly believes that encouraging savings will be a tremendous help to our nation in its battle against inflation. As people begin saving more, they are necessarily consuming less, thereby denying the fuel that fires inflation. But, with runaway inflation and heavy individual tax burdens, traditional savings investments can no longer attract capital.

New incentives are needed, not only to attract but to retain America's savings dollar. The tax-deferred rollover account and Universal IRA plan are the type of incentives which will recapture America's savings dollar and stimulate badly needed productive investment.

The time to act is now. The longer we wait, the further behind we fall in our efforts to stem inflation, provide economic growth, assure an adequate housing stock, increase employment and maintain the value of the follar. Increased savings will benefit business, industry, productivity and, most importantly, every American citizen.

We urge members of the Finance Committee to act on this issue in an expeditious manner so that investing in America through savings will once again be profitable.

STATEMENT OF
AMERICAN BANKERS ASSOCIATION
SUBMITTED TO
SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT
SENATE COMMITTEE ON FINANCE
ON
S. 2446

July 11, 1980

The American Bankers Association is a trade association composed of over 90% of the more than 13,000 full service banks in our country. The Association fully supports the intent of this legislation to increase savings and make available more capital for American businesses and home building. However, we are concerned that the mechanism proposed which includes a fixed interest rate ceiling on deposits, a designated list of qualifying loans and a fixed interest ceiling on the loans is unworkable and unadvisable. Congress only this year decided that interests rates paid on savings should not be subject to legislative ceilings and directed the phasing out of the ceilings now in place. Similarly, Congress has been struggling with the problems created by interest rate ceilings on loans. S. 2446 not only is a step backwards in these two areas but it also allocates credit. In addition, it limits the taxpayer's non-includible amount of interest by the size of the deposit and this brings an additional complexity for taxpayers into the Internal Revenue Code.

We do not believe the free enterprise system would be enhanced by legislation that interferes with the marketplace by placing a ceiling on interest rates that can be received by depositors, allocating the credit made available by such funds and fixing the price of such credit.

The need for additional incentives for savings is clear but the restrictions and limitations of S. 2446 would defeat its purpose of encouraging the growth of our free economy.

J.L.Kellogg
Graduate School of
Management
NORTHWESTERN UNIVERSITY

July 14, 1980

Michael Stern
Staff Director
Committee on Finance
Room 2227
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Stern:

I have had the pleasure of appearing before the Ways and Means Committee in the past to testify in support of legislation that would defer the taxation of reinvested dividends until the securities that are purchased would be sold.

I would like to urge your adoption of this legislation at this time.

I know from a careful and thorough study that I have just completed on electric utilities that one can hardly overstate their need for equity capital. Yet these companies are bound by tradition and sound financial reasons to disperse a large portion of their earnings in the form of dividends. This legislation would be a step in the direction of restoring investor confidence in this industry.

Because of prior academic committments, I am not free to appear before you, but I would like to have you consider the following statement and ask if I may have it placed in the record.

The arguments in brief that I advance in favor of this legislation are that

(1) The legislation would increase the flow of equity to companies that pay out a large percentage of the earnings. As a result these firms will have increased capacity to carry on investment programs. These programs in turn can stimulate increases in productivity as well as lead to greater employment opportunities.

(2) Shareholders who currently elect to reinvest their dividends now pay taxes even though they do not receive any cash proceeds. From their point of view, the ownership of their shares results in an adverse cash flow. They may therefore have little incentive to participate in the program.

(3) The pressures of inflation on firms has increased the corporate need for new capital. If an excessive amount of the required funds are to be in the form of debt, the financial stability of many firms may become questioned, because they may have difficulty in meeting their debt service charges during a period of recession.

Sincerely yours,

Eugene Lerner
Professor of Finance

EL/RR
Enclosures
cc: John M. Martin, Jr.
Chief Counsel, Committee on Ways and Means

STATEMENT OF EUGENE M. LERNER, PROFESSOR OF FINANCE, J.L. KELLOGG GRADUATE SCHOOL OF MANAGEMENT, NORTHWESTERN UNIVERSITY, EVANSTON, ILL.

Mr. Lerner. I want to speak in favor of legislation designed to defer the taxation of dividends when these funds are reinvested in the stock of the paying corporation. I believe such legislation will have the effect of increasing a corporation's equity and the funds available for capital expenditure. As these capital outlays take place, the productivity of the firm's labor force will increase and new employment opportunities will be created.

Corporations must continuously make a series of trade offs between paying dividends and undertaking capital expenditures and between raising debt capital and equity capital. I would like to consider each decision in turn. Firms must continue to make capital expenditures if they are to remain competitive and expand the opportunities they offer their customers, employees, and shareholders.

To carry out these expenditures, however, they first must have the financial resources; and, in the short run, the smaller the dividends, the more funds there are that are available. On the other hand, firms must also pay dividends to their shareholders. No one makes an investment in any entity without some expectation of a return.

Dividends constitute a large part of the total return that any investor receives, and many investors, such as pension funds and profit-sharing plans, require dividends to meet their commitments to their beneficiaries. Moreover, since interest rates are now so high on U.S. Government bonds and other money market instruments, no one will invest in common equity unless he expects to earn at least as much on the equities as he could earn on these very safe alternative investments. As a consequence, the lower the firm's capital expenditures, the larger the dividends that can be paid and in the very short run the higher the return that the investor receives.

However, just as a car can go faster if it has brakes, in the long run a firm will be able to pay more dividends if it forgoes some today and makes some capital expenditures. The reason for this is that the firm will then continue to have productive assets.

Corporations also face a trade off with respect to how they raise the funds they need to make their capital expenditures and pay their dividends. They can raise funds by either borrowing debt or increasing their equity. If they borrow all the funds they need, however, they face the twin problems of paying high interest rates and increasing the riskiness of the firm. Risk increases because the debt represents a claim against further cash flows.

Chrysler, for example, would never have had to come to the Congress for aid if it had had more equity and less debt. The smaller the dividends that a firm pays, the faster its equity will grow and the less its need to borrow money. On the other hand, if a firm were to finance all its capital expenditures and dividends entirely with equity and forgo the use of all debt, it would not be following a prudent policy. Firms can increase their earnings if they earn more on their assets than they pay in interest on the debt. Moreover, if the amount of debt issued is not excessive, the riskiness of the firm will not increase by an appreciable amount.

Just as firms want to do both--pay dividends and make capital expenditures--so they want to both finance their outlays with some debt and some equity. A major financial policy problem of all corporations is, therefore, how to balance these four activities. The critical variable in this process is the size of the firm's equity and how fast it grows. The larger the equity base and the faster if grows, the more money firms can safely borrow and the faster they can expand the plant.

It is at this point that the dividend reinvestment plan enters. It plays a strategic role because it permits the firm to provide a return to its investors and at the same time enables the investor to increase the equity of the firm.

If the investor must pay taxes on the dividends he reinvests, however, he has less incentive to join the program. He will be paying taxes but will not have the cash flow provided by the dividends to make the payments. On the other hand, if taxes could be deferred until the shares that are purchased through the dividend reinvestment plan are sold, the investor would have a strong incentive to reinvest his dividends. Firms will thereby increase their equity and be able to expand their capital outlays.

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